

## QUARTERLY REPORT ON THE SPANISH ECONOMY

## 1 Overview

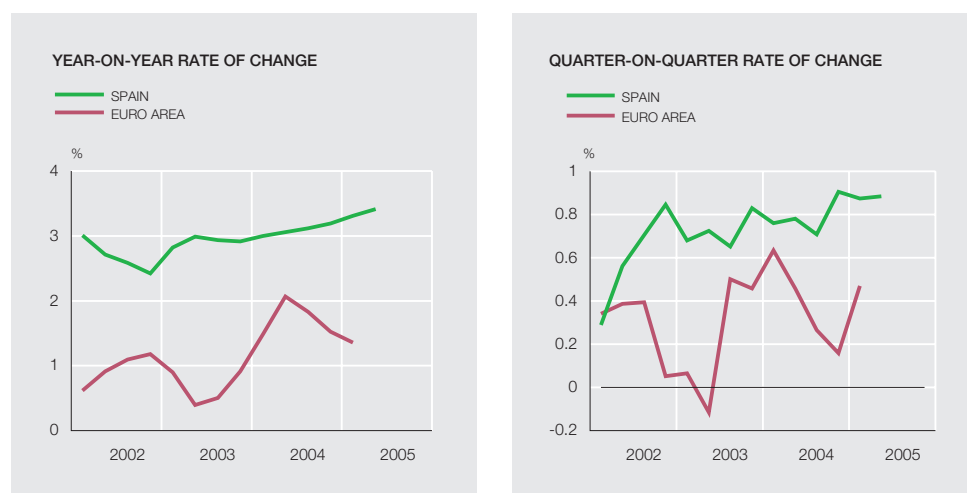
The base year 2000 Spanish National Accounts (CNE 2000) data, released by INE in May, show significant changes in the estimated growth of the most important aggregates, such as output and employment. But they have not substantially altered the diagnosis of the recent performance of the Spanish economy, whose most characteristic features have been reinforced<sup>1</sup>. The high growth rate of economic activity (3.1% per annum in the period 2001-2004), underpinned by the momentum of domestic spending and, in particular, by household demand, and the capacity to generate employment (with an average increase of 2.7% over this same period) remain the key factors behind this performance, which places the Spanish economy among the group of developed economies that has posted the best results in recent years. The new estimates continue to highlight how this sound behaviour has been accompanied by less satisfactory results in the external sector sphere, and by comparatively high growth in costs and prices, when the euro area is taken as a reference. Nonetheless, the release of the CNE 2000 figures is still ongoing (for instance, the non-financial accounts of the institutional sectors are not yet available), and it will therefore be necessary to await such information to complete this analysis.

Over recent quarters the new QNA figures, in keeping with the CNE 2000 data, have shown the year-on-year growth of GDP, which stood at 3.3% in 2005 Q1, to be on a slightly rising path (see Chart 1). This mild acceleration has resulted from a marked surge in domestic demand, which climbed by 5.5% in Q1, underpinned by the buoyancy of all its components, and especially of investment in equipment. Meanwhile, the negative contribution of external demand to growth increased progressively, reaching -2.5 pp at the start of the year. The information for Q2 points to a further acceleration in output, with a 3.4% rise in relation to 2004 Q2, with its quarter-on-quarter growth rate holding at 0.9%. The job-creation figures, which have remained very favourable over recent months, corroborate this fresh acceleration. Further, there are certain signs that the briskly rising path of domestic demand may have been checked, with its rate of increase stabilising, while the negative contribution of the external sector would have lessened, as exports ceased to decline as they had in the first three months of the year. Nonetheless, the behaviour of domestic spending and net external demand remain very divergent, and there is still no significant turnaround perceptible in the composition of growth. The inflation rate stood slightly above 3% in June, so that the differential with the euro area is holding at around 1 pp.

Although the strong rise in oil prices has been the key development on the recent international economic scene, mention should also be made of the strength of the dollar and the recent reform of the exchange rate regime in China, which has formally pegged the value of its currency – the renminbi – to a basket of currencies. The fresh surge in the price of oil, which took it to highs of over \$60 per barrel in July, compounding those seen since the start of the year, has come about against the background of a notably buoyant world economy. Though the global economy has slowed in relation to the forceful pace witnessed in 2004 (5.1%), it has done so to a lesser extent than expected. Specifically, the US economy posted robust growth in the opening months of the year. Among the Asian economies, the increases in Chinese and Indian activity were at least as high as those in 2004, while Japanese growth in the first quarter was also surprisingly high, albeit without outpacing its early 2004 levels. However, there was a

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1. See the article "La Contabilidad Nacional de España, base 2000. Principales cambios e implicaciones para los agregados macroeconómicos", in the June 2005 edition of the *Boletín Económico*.



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

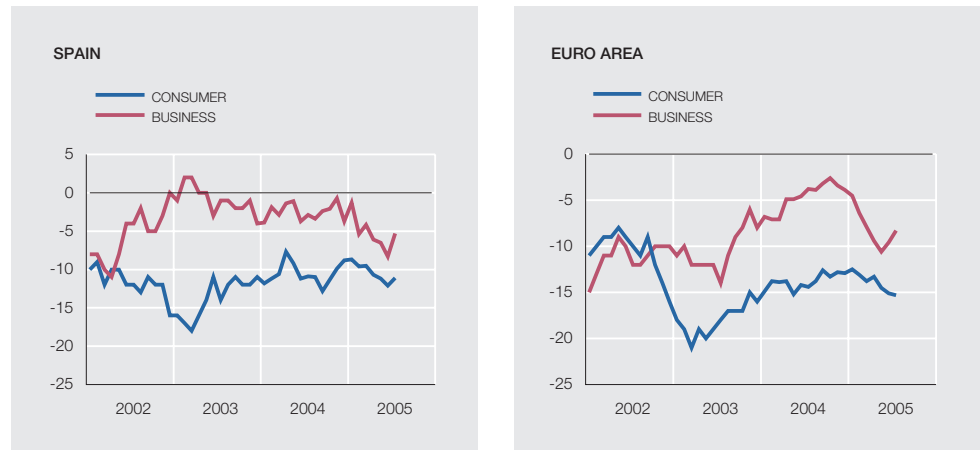
slowdown in activity in the south-east Asian countries, induced by weakening exports. Latin America also saw growth decline in the opening months of the year owing to the lower contribution of external demand and to the moderation of domestic demand; that said, GDP growth in the region as a whole stands at around 4%. In any event, the slowdown appears to have taken greater root in the new EU Member States and in the United Kingdom, while in the euro area growth remains flat at a low rate.

Overall, economic policies continue to be conducive to growth, given the general easing of inflation rates, although differences in stance are discernible depending on how expansionary the position of the different economies is. The Federal Reserve has announced successive rises in the federal funds rate, without this having yet entailed a clear tightening of monetary conditions. Long-term interest rates have thus held at very low levels, feeding through to the financing conditions on international markets and giving rise to a widespread reduction in risk premia and to a narrowing of sovereign debt spreads. In turn, the securities markets have posted moderate rises, which have been more significant in the euro area.

Despite the relatively sound results for the world economy at the onset of 2005, the short and medium-term risks for the international scenario have gradually heightened. Global imbalances and, in particular, the US external deficit have continued to widen, and the dollar's appreciation since the start of 2005 tends to hamper any mild absorption of such risks. There is, moreover, a possibility that long-term interest rates will ultimately rise, lessening the easiness of financing conditions.

Finally, the strong rise in oil prices and their high volatility have been accompanied by both upside and downside risks to their future course. Although the uncertainty associated with oil prices is widespread, the impact of their movements on global activity might be comparatively moderate in the light of the effects seen most recently.

As has been the case for more than four quarters, economic activity in the euro area in the first half of 2005 has remained notably sluggish. Growth in Q1, at a quarter-on-quarter rate of 0.5%, which was apparently better than that in the second half of 2004, was affected by a statistical adjustment to the German figures which, once taken into account, highlights anew



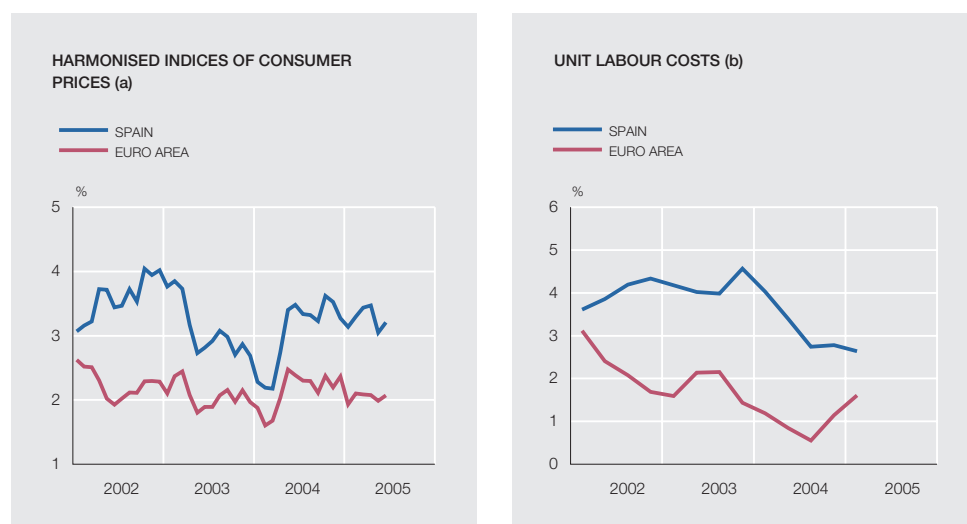
SOURCE: European Commission.

the scant momentum of European internal demand. And this was accompanied, on this occasion, by negative exports results, which were also seen in other geographical areas. The information for Q2 and the projections available for GDP growth in this period point to the continuing slackness of output, albeit with a somewhat more favourable composition as a bigger increase in internal demand and a rise in imports are taken on board. The consumption indicators remain depressed, however, reflecting the low level of confidence characterising household spending decisions (see Chart 2). Country by country, significant differences in behaviour persist, with the area's biggest economies – notably Italy, Germany and, to a lesser extent, France – continuing to post the worst figures.

Inflation in the euro area held at 2.1% during Q2, upheld by the increase in energy prices. Meantime, underlying inflation, measured by the less variable components of the HICP, stood at a much more moderate level (see Chart 3). The outlook for consumer price growth to the end of the year is one of stability around the current level, against the background of still-high oil prices. Nonetheless, while the pass-through of energy price increases to other related products cannot be ruled out, there are no signs that there will be widespread second-round effects on prices and wages to prevent inflation from resuming a rate of below 2% during the coming year. Indeed, the behaviour of wages remains very moderate. In these circumstances, the ECB Governing Council has kept its official interest rates stable, deeming current levels to be compatible with price stability and consistent with moderate economic growth. Both nominal and real interest rates are thus at historical lows, keeping monetary and financial conditions in the area relaxed.

Albeit with sizable differences across the member countries, the overall trend of public finances in the euro area reveals the difficulties in meeting the fiscal rules in place in the current low-growth setting. The degree of compliance with the fiscal targets set in the stability programmes remains limited and a significant number of countries, including Germany, France and Italy, are immersed in different stages of the excessive deficit procedures. The changes made by the European Council in March to the Stability and Growth Pact rules are already in force, though it is still too soon to assess whether the greater flexibility the new rules provide is accompanied by sufficiently stringent application, as the proper functioning of the Monetary Union requires.

The generous monetary and financial conditions in the euro area, the sound financial position of European corporations and the lesser pressure on the industries most exposed to interna-



SOURCES: Eurostat, ECB and INE.

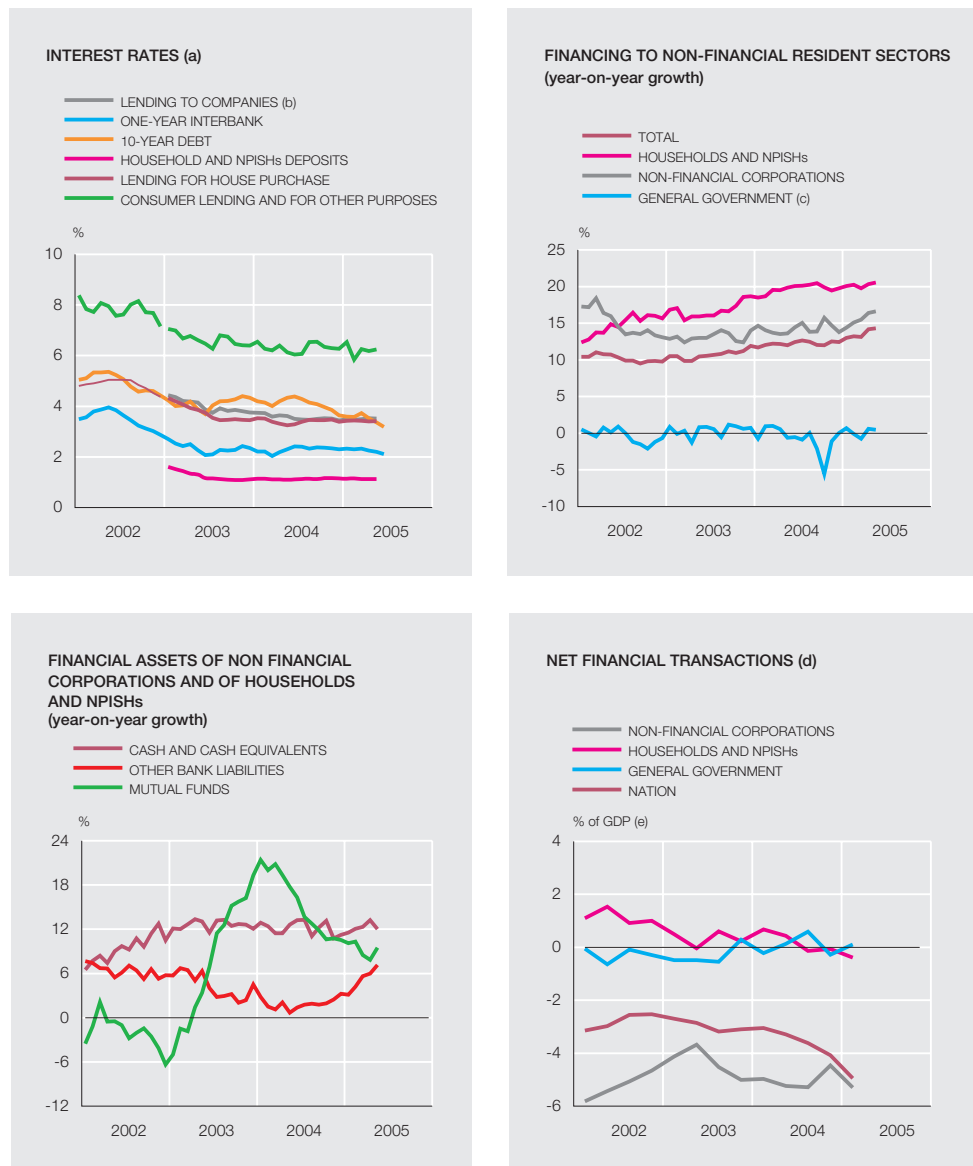
a. Year-on-year rate of change.

b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

tional trade, in the light of recent foreign exchange market developments, shape a favourable situation for the region's economy to resume a growth rate more in keeping with its potential. Yet it cannot be ruled out that the low level of confidence consumers and businesses still show will continue to hold back the recovery, or that those more structural factors which have checked this recovery will continue to exert a similar effect. It is thus important that, following the course mapped and assumed by the European Council and the Commission, the Member State governments should adopt the measures needed to resolve the structural problems of their economies that are at the root of low growth.

Largely removed from the course followed by the core euro area economies, the Spanish economy saw high and slightly rising growth during 2004 and 2005 Q1. As indicated at the start of this Report, and on the basis of the indicators available, this trend is estimated to have held firm in Q2, placing year-on-year GDP growth at a rate of 3.4%. Although domestic demand tended to check the strong acceleration experienced in the previous quarters, and while the deterioration in net external demand was contained, no significant changes in the basic determinants of growth are discernible. These continue to turn on the easiness of monetary and financial conditions, underpinned by fresh rises in household wealth, on the growth of employment, which sustains their disposable income, and on the expansion of the world economy, which contributes to raising companies' demand expectations. While losses in price and cost competitiveness continue to be seen, set against still-low productivity gains, the course of the exchange rate has lessened the intensity of the pressures on those industries most exposed to competition.

The forceful buoyancy of household consumption since mid-2004 (at over 4.5%) has largely exceeded the estimated increase in household disposable income, giving rise to an appreciable reduction in the saving ratio. This behaviour is linked to the powerful effects being exerted on household spending by the rise in their wealth, driven by the increase in real-estate asset prices (which, despite having eased somewhat in Q2, are still showing no signs of a turnaround and continue to rise at a double-figures rate) and, more recently, by the rise on stock markets. The growth of residential investment, additionally boosted by the low cost of mort-



SOURCE: Banco de España.

a. There is a break, in January 2003, in the series of banking rates owing to changes in the data compilation statistical requirements.

c. Consolidated financing: net of securities and loans that are general government assets.

d. Cumulative four-quarter data.

gage financing, has hardly eased, as confirmed by the rate of increase of financing received by households in this connection, which stands at over 24%. As a result, households are estimated to have continued to increase their net demand for financing in 2005 to date, while their debt ratio has once more increased.

The rapid acceleration in investment in equipment last year is in step with the sound conditions in place for pursuing new investment projects, in an environment in which the cost of certain types of financing has even fallen. That explains why the growth of flows of borrowed funds at companies has increased to a rate of 16% (see Chart 4). Nonetheless, the information available on the behaviour of this spending component in recent months would suggest this acceleration has been curbed somewhat, though the related year-on-year growth rate remains high. The continued momentum of investment is largely linked to the increase in domestic con-

sumer demand and construction, but it is also tied to the expectations of growth in foreign markets and to companies' capacity to hold firm in such markets.

In this respect, the pick-up seen in goods exports in Q2, following the highly negative results obtained in Q1, gives credence to the perception that the decline in foreign sales in Q1 was partly due to a general fall-off in trade flows and not only to a further deterioration in the ability of Spanish products to maintain their position in foreign markets. The depreciation of the euro in the first half of 2005 has also helped enhance exports, an improvement which has spread to tourism. In turn, imports have been boosted by the growth of demand, which has been most marked in capital goods, although the course of the exchange rate is checking their growing rate of penetration in the domestic market. In sum, the data available point to net external demand subtracting less from growth in Q2, though it will continue to do so intensively. In any event, export growth continues to be below that of markets and the external deficit is widening rapidly, both of which trends confirm that the cumulative losses in competitiveness are bearing on the economy's capacity to generate value added.

The resilience of residential investment and the momentum of public investment explain why construction is the most dynamic branch of activity, with an increase of around 5.5% in its value added during the first half of the year. Likewise, the buoyancy of consumption would partly account for the growth of market services. The thrust of activity is concentrated in these two branches, while industry has been markedly slack, in line with the competitive pressures to which it is subject. From the standpoint of job creation, the pattern across the various productive activities is even more differentiated, and is reflected in apparent labour productivity. Hence in construction and market services, output per person employed is scarcely increasing or is even falling (as is the case of construction), while in industry, where employment has fallen off, productivity gains are proving high. As the recently released EPA (Labour Force Survey) data confirm, employment growth has stepped up in the first two quarters of 2005, at the level of both the economy as a whole and of the market economy, in step with value added, thereby holding the rate of increase of productivity at a very low rate of below 0.5%.

Notwithstanding the more moderate trend of wages highlighted by the new CNE 2000 figures (reflecting the presence of significant composition effects due to strong employment creation in low-wage jobs), the information available on wage-setting in 2005 points to an acceleration. This higher wage growth is prompted, first, by the impact of the indexation clauses of last year's collective bargaining agreements and, second, by the rise in wage settlements in newly signed agreements, which stand at 3.4%, though these agreements so far affect only a small number of wage-earners. The increase in compensation, combined with the scant rise in productivity, entails maintaining a rate of increase in unit labour costs that clearly outpaces that of other EU countries.

Price developments likewise point to a continuing and significant inflation differential. Although the CPI has slowed slightly over Q2 as a whole, its 12-month growth rate remains above 3%. This is due in part to the upward impact of dearer energy, but it also reflects the inertia of services prices, the growth rate of which has scarcely changed in recent years: their twelve-month rate in June was 3.7%, similar to the annual average for the two previous years. In these circumstances, the moderation in consumer goods prices, as a result of the inflow of lower-price imports, has merely made for greater duality between the inflation rates posted by the sectors exposed to and those sheltered from competition.

Undoubtedly, part of the difference in respect of the growth of costs and prices in Spain is attributable to the strength of demand. This very strength would lie behind the notable increase

seen in public revenue in the first half of the year, according to the State budget outturn figures. Indeed, these figures would be consistent with a higher-than-forecast general government surplus at the end of the year, albeit maintaining a neutral fiscal policy stance. However, given the pressure that the notable expansion of domestic demand is exerting on the productive system, it is vital here that fiscal policy should continue to be geared to stabilising expenditure and contributing to its orderly moderation.

The performance of the Spanish economy in the first half of 2005 shows scarcely any changes from its previous trends. In particular, there are still no perceptible signs of the imbalances that have built up in recent years being corrected. In this situation, it is important that the design of economic policy be oriented first, to preserving macroeconomic stability, and further, to reinforcing long-term growth potential, through a strategy of reforms geared to promoting productivity and to improving the economy's competitive bases. In this connection, the Government unveiled its "Ingenio 2010" programme in late June. This programme entails a broad range of measures designed to boost R+D+i activities and the development of the information society, in line with the Lisbon Agenda objectives. As is known, the Spanish economy lags somewhat behind the core European countries in these two areas. Conclusively closing this gap will be fundamental to achieving far-reaching advances in productivity growth.



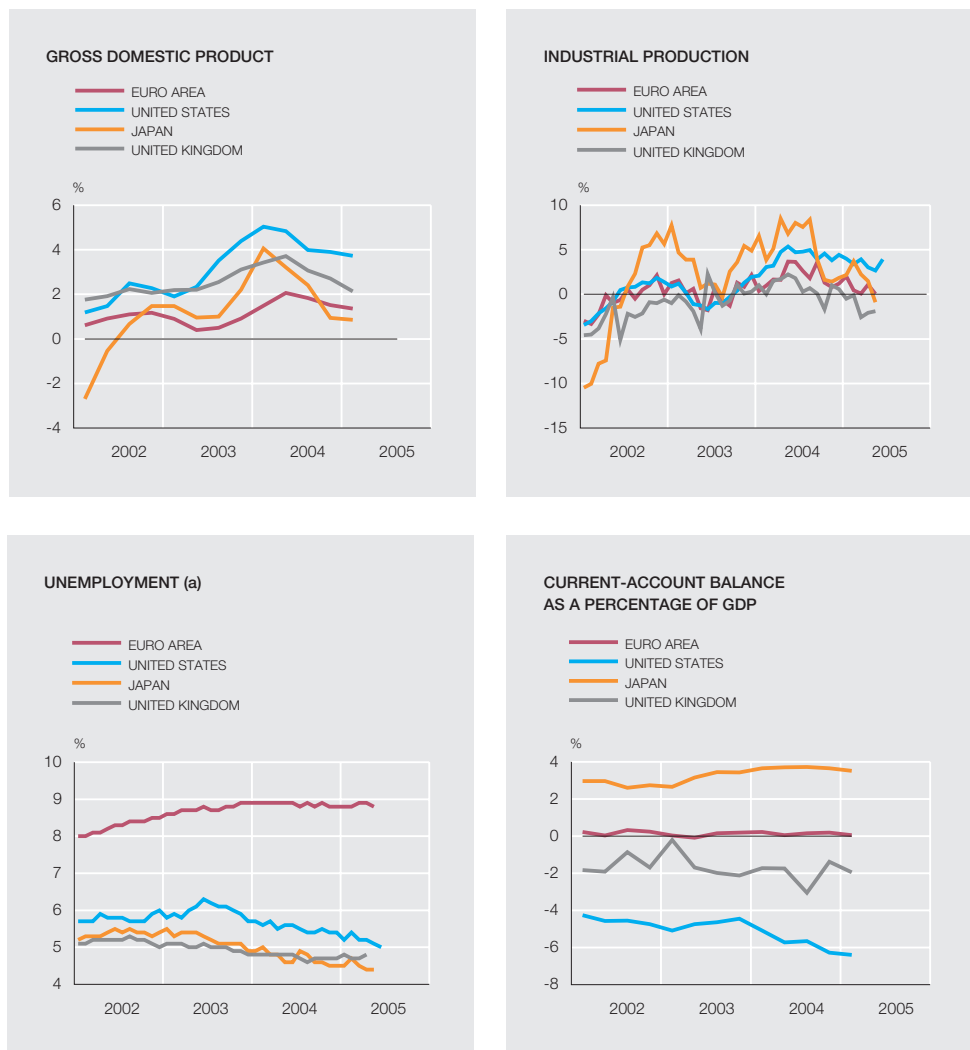
## 2 The external environment of the euro area

In 2005 Q2 the international economic outlook was affected by the rise in and high volatility of oil prices. After standing at a level of over \$55 per barrel at the start of the quarter, the price of Brent fell to \$48 per barrel in mid-May and subsequently rose by more than 25% to an all-time high of \$60 per barrel in the first week of July. This rise might be explained by the expectations of increased demand for crude in the second half of the year and a limited surplus production and refining capacity. Moreover, the prices of futures contracts remained above spot prices for an increasingly longer horizon, now stretching to 24 months.

As regards international financial developments, the dollar was notably strong, markedly so in relation to the euro. This was against an economic background characterised by the sustained momentum of the US economy, compared with the moderate growth and bleaker outlook in the euro area. The US Federal Reserve raised its official interest rate by a further quarter-point at the end of June to 3.25%. In its communiqué, the Fed signalled that the process of rate rises would continue in the coming months, whereby market expectations are factoring in a reference rate of between 3.75% and 4% at the end of the year. In turn, long-term interest rates in the United States continued to fall until late June, although they rebounded moderately thereafter. The spreads on low-grade corporate bonds tended to narrow, after widening strongly the previous quarter, largely as a result of the crisis in the automobile sector, while stock markets posted widespread though moderate gains. The emerging markets also performed favourably, especially the new EU Member States, and this was reflected in an across-the-board reduction in sovereign bond spreads and in stock market gains in most countries.

In the United States, GDP in Q1 increased by 3.8% in annualised quarter-on-quarter terms, following the upward revision of the initial two estimates. This meant an increase which was the same as that in 2004 Q4. In relation to the same quarter a year earlier, the related rise was 3.7%, compared with 3.9% the previous quarter. The composition of growth compared with the previous quarter is not very favourable, judging by the strong deceleration in business investment and the diminished momentum of private consumption, although the contribution of the external sector was less negative. The indicators for Q2 showed signs of something of a slump in activity to end-May, which may have been influenced by the rise in hydrocarbons prices. In June, however, there was a generalised improvement in indicators such as industrial production, the manufacturing and nonmanufacturing ISM indices, durable goods orders and retail sales. The latest employment data for June, though not extraordinary, point to a pick-up in the labour market. Indeed, the unemployment rate stood at 5%, the lowest figure for the past four years. The consumer price index has moved in step with energy prices: after rising in April, it gradually fell to a year-on-year rate of 2.5% in June. The underlying inflation rate, however, has held at a moderate level, standing at 2% in June. Finally, the imbalances in the US economy persist, although the fiscal situation has improved. The Government revised the federal deficit forecast for fiscal year 2005 down from 3.5% of GDP to 2.7%, thanks to the favourable course of revenue and to the containment of public spending. The trade deficit in 2005 to May grew by 20% compared with the same period a year earlier and, despite the favourable figure for May, it shows no sign of diminishing, all the more so given the strength of the dollar.

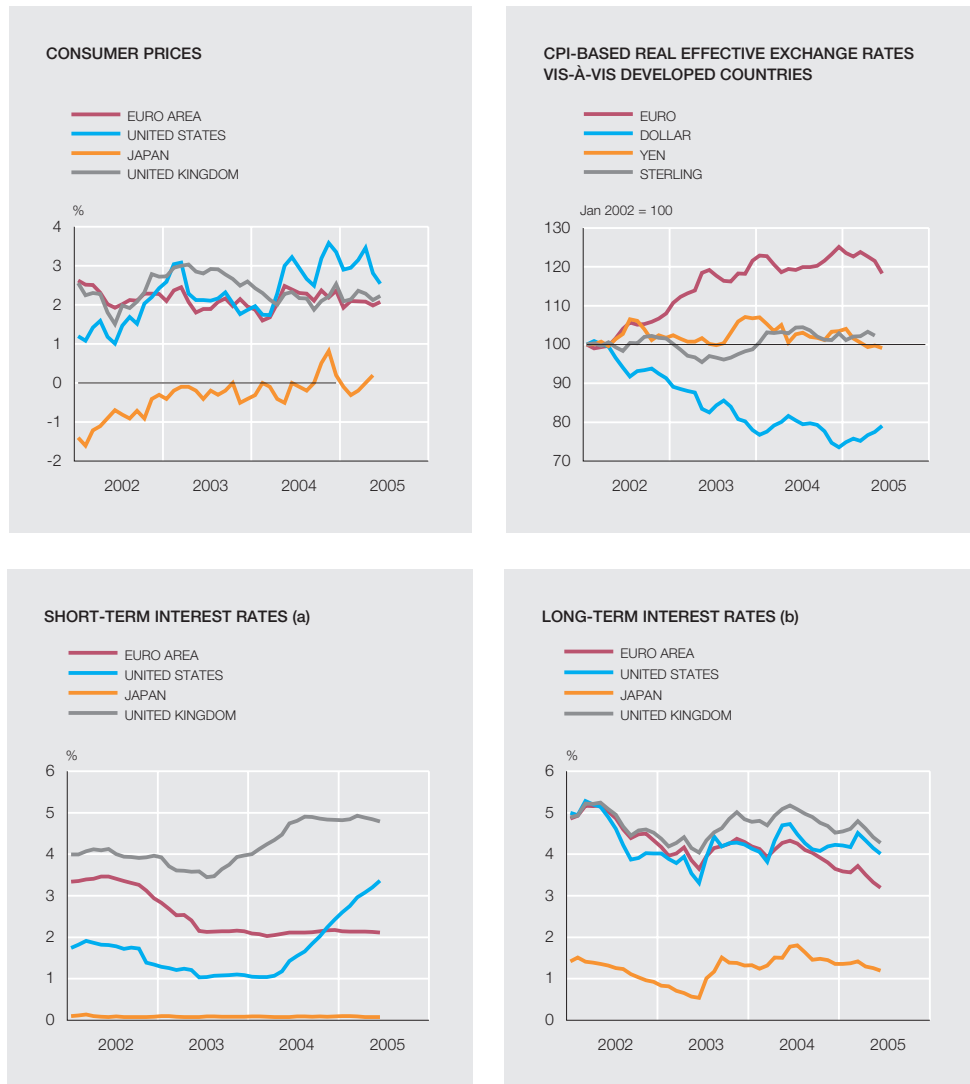
In Japan there was a strong and unexpected acceleration in growth in 2005 Q1, entailing a year-on-year change in GDP of 1.3% (compared with 0.6% in 2004 Q4), equivalent to 4.9% in annualised quarterly terms (against 0.2% the previous quarter). Underpinning this buoyancy was the favourable trend of private investment and consumption, which countered the dimin-



SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of the labour force.

ished momentum of external demand. The indicators for Q2 are ambivalent, meaning growth as strong as that in Q1 is not expected. On the supply side, industrial production slowed to May, while the business indices recovered slightly in May, and business confidence at the large manufacturing corporations (drawing on the Tankan survey) improved in Q2. On the demand side, retail sales performed erratically, and household income fell in May. By contrast, developments on the labour market in May were favourable, with job creation standing at a year-on-year rate of 0.7% after posting zero or negative rates, while the unemployment rate stood at 4.4%, the lowest figure for the past six years. One of the more adverse aspects was, however, the weakness of the external sector. Exports slowed strongly in May, despite the depreciation of the yen. In turn, imports quickened to 21.2% that same month, in line with higher oil prices. Lastly, deflationary pressures appear to have abated during the quarter. In May, the consumer price index posted a 12-month growth rate of 0.2%, compared with 0% in April and negative rates in the previous months. The underlying inflation rate was 0% in May, against -0.2% in April. Against this background, the Bank of Japan confirmed that it will maintain the current account target, although it will allow specific deviations in order to adjust the system's liquidity requirements.



SOURCE: Banco de España.

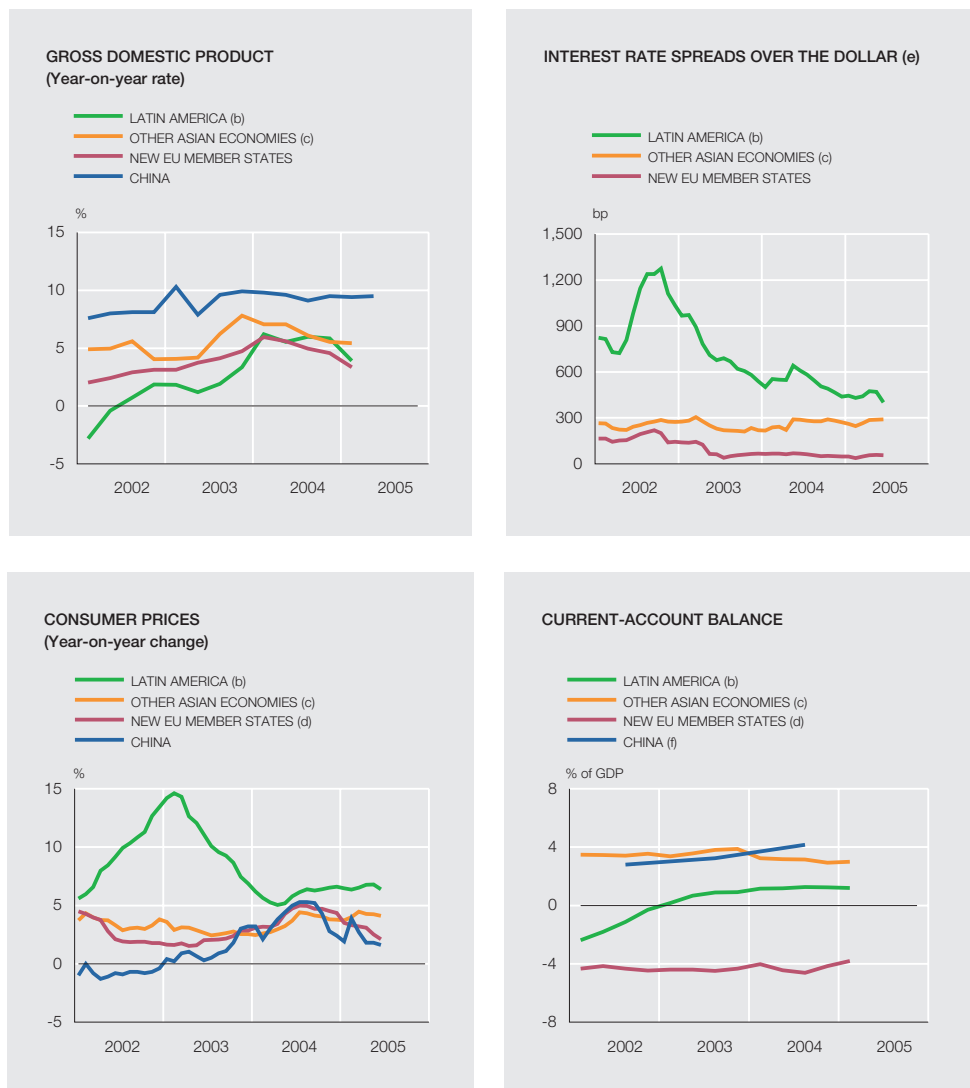
- a. Three-month interbank market interest rates.  
b. Ten-year government debt yields.

In the United Kingdom there was a clear slowdown in activity in the first half of the year. The initial estimate of GDP for Q2 indicates growth of 1.7% compared with the same period a year earlier, against 2.1% in Q1 and 2.7% in 2004 Q4 (1.5% in annualised quarterly terms, compared with 1.5% and 2.2% in the previous quarters). The data for Q1, the last to be broken down by demand component, showed that this slowdown was mainly due to the lower growth of private consumption and to external demand subtracting more from GDP growth. Despite the slight improvement in some indicators in June, the data for Q2 confirm that the deceleration has continued. As regards prices, the inflation rate, measured by the HCPI, increased once more from 1.9% in May to 2% in June, coinciding with the Bank of England's target. House prices continued to slow in June to an annual growth rate of between 2% and 4% for the main indices. Against this backdrop, the market has discounted a reduction in the official interest rate at the next Bank of England meeting, after its having held constant at 4.75% since August 2004.

In the new EU Member States, GDP growth slowed in 2005 Q1 as a result of the lesser buoyancy of domestic demand. The slowdown was most marked in Poland, Hungary and Slovenia. Nonethe-

**EMERGING ECONOMIES:  
MAIN MACROECONOMIC INDICATORS (a)**

CHART 7



SOURCES: National statistics and JP Morgan.

- a. Three-month interbank market interest rates.
- b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
- d. Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia.
- e. JP Morgan EMBI spreads. The EU acceding country data relate to Hungary and Poland. The Asia aggregate does not include China.
- f. Annual data.

less, the partial indicators for Q2 point to a pick-up in growth, based on the sound industrial production and retail sales figures. The public finances position varies greatly from country to country: it is particularly worrying in Hungary and favourable in the Czech Republic and Slovakia. As for inflation, the consumer price index trended very favourably, although there was a rise in some countries in June. The sound behaviour of prices and the economic slowdown in Q1 allowed official interest rates to be cut in the main countries (Hungary, Poland and the Czech Republic). Finally, the currencies of Cyprus, Latvia and Malta joined the Exchange Rate Mechanism (ERM II) on 2 May. In general, the currencies in ERM II held stable at around their central parity, without any significant pressures.

In Asia, the Chinese economy was once again very dynamic, growing at a year-on-year rate of 9.5% in 2005 Q2, 0.1 pp up on Q1 and above the official forecasts. The indicators of activity,

especially industrial production and fixed assets investment and, to a lesser extent, retail sales, confirmed this buoyancy. The surplus on the trade balance has progressively widened during the year to \$9.7 billion in June. The reason is the slowdown in imports, to a year-on-year rate of around 15%, while exports have continued to grow at a rate of 30%. Despite the robustness of activity and the increase in producer prices, owing to dearer oil, the slowdown in food prices contributed to the reduction in the consumer price index in recent months to 1.6% year-on-year in June. Recently, moreover, the Chinese authorities have announced a reform of the exchange rate regime of the renminbi, pegging it formally to a basket of currencies with an initial central parity of 8.11 yuan per dollar and fluctuation bands of 0.3%, which entails a re-valuation of 2.1% against the dollar. In the other economies in the region, growth in India quickened in Q1 to 7% compared with the same quarter a year earlier, while growth slowed in south-east Asia, especially in Thailand and the Philippines. The slowdown in exports in Q2 was relatively generalised in south-east Asia, suggesting the moderation in growth is proving quite persistent.

There was a notable deceleration in growth in Latin America in Q1 to 4% from 5.8% at end-2004. Although this is partly due to a base effect, the loss of buoyancy in external demand – which subtracted almost 1 pp from growth – and the moderation of the rate of expansion of domestic demand should also be mentioned. The reduction in growth was particularly sharp in Brazil and Mexico. Nonetheless, the indicators for Q2 were relatively favourable, meaning the slowdown is not expected to intensify. The rise in inflation, which had prompted a continuation of the upward cycle in interest rates, has shown signs of moderating, especially in Brazil and Mexico, allowing these countries to ease their monetary policy. The financial indicators behaved soundly, despite the political turbulence in some countries.

### 3 The euro area and the monetary policy of the European Central Bank

In 2005 Q2, economic activity – and domestic demand in particular – remained sluggish in the euro area, in line with the trends observed since the second half of 2004. The latest information available for Q2 points on the whole to a moderation in GDP growth, which is only partly in response to the reversal of the calendar effects that tended to increase the figures for Q1. Taking a more medium-term view, the favourable monetary and financial conditions in place, along with the relatively sharp growth of world trade, should pave the way for a sustained recovery in economic activity. The main factors of uncertainty in this scenario of progressively strengthening activity stem from the persistence of high oil prices, from the possibility of a sharp correction in the existing global imbalances and from the low levels of consumer and business confidence.

Turning to inflation, the short-term outlook has been influenced by the materialisation of the risks highlighted in previous quarters concerning oil prices which, in the case of Brent oil, had risen to \$59 per barrel at the end of June. The combined effect of high oil prices and, to a lesser extent, of the recent depreciation of the euro may mean that inflation in the area will not dip below 2% over the rest of 2005. Further ahead in the medium term, inflationary expectations remain contained, largely as a result of the moderation of wage increases against a background of modest growth and sluggishness in the labour market. The factor of most uncertainty concerning future prices is the course of the price of oil.

In these circumstances, the ECB Governing Council has held official rates stable, considering that they will only be consistent with the favourable outlook for continuing price stability against a background of relatively sluggish economic activity.

Ultimately, the French and Dutch rejection of the European Constitution and the terrorist attacks on 7 July in London do not seem to have greatly impacted the financial and foreign exchange markets. However, the referendum results appear to have contributed to the moderate depreciation seen in the euro.

#### 3.1 *Economic developments*

On euro area National Accounts estimates for 2005 Q1, GDP increased by 0.5% in relation to the three previous months (see Table 1), thereby exceeding the growth recorded in the two preceding quarters. This acceleration can be explained by two factors which suggest that we are not yet at the start of a more sustained growth phase. These were, namely, the effects of a statistical adjustment which bore on the main economy of the area, and the reduction in imports. The contribution of internal demand, excluding inventories, was only 0.1 pp (after having grown by 0.6% in quarter-on-quarter terms in 2004 Q4), owing to the moderate growth in private consumption and the slide in gross fixed capital formation. The poor behaviour of this latter component was the result of the notable deterioration in investment in construction, due largely to the bad weather in Germany, while investment in equipment posted a growth rate of 0.5%, up on the previous quarter. Box 1 shows the course of the gross fixed capital formation components over the recent period. Government consumption held stable and the contribution of stockbuilding to growth was zero. Finally, the fall-off in purchases abroad offset the effect of the decline in exports and boosted the contribution to output of the external sector to 0.4 pp, more than half a point above the contribution in the final quarter of the previous year (see Chart 8).

The breakdown of National Accounts by country shows that the higher growth in the euro area as a whole in Q1 was due to the performance of the German economy, since the other coun-

	2003	2004				2005		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2 (a)	Q3 (b)
GDP								
Year-on-year growth	0.9	1.5	2.1	1.8	1.5	1.4		
Quarter-on-quarter growth	0.5	0.6	0.5	0.3	0.2	0.5		
European Commission forecasts (c)							(0.1 ; 0.5)	(0.2 ; 0.6)
IPI (d)	1.4	1.1	2.9	2.6	1.1	1.0	0.5	
Economic sentiment	97.6	98.6	99.9	100.6	100.9	99.0	96.3	
Industrial confidence	-8.0	-7.0	-5.0	-3.7	-3.3	-6.3	-10.0	
Manufacturing PMI	52.0	52.8	54.4	53.9	51.4	51.4	49.3	
Services confidence	10.7	11.3	11.7	12.0	11.0	10.7	9.0	
Services PMI	56.7	56.0	55.2	54.4	52.9	53.1	53.1	
Unemployment rate	8.8	8.9	8.9	8.9	8.8	8.8	8.8	
Consumer confidence	-16.0	-14.3	-14.3	-13.7	-13.0	-13.3	-14.3	
HICP (d) (e)	2.0	1.7	2.4	2.1	2.4	2.1	2.1	
PPI (d) (e)	0.9	0.4	2.4	3.3	3.6	4.3	3.5	
Oil price in USD (e)	29.9	33.8	35.3	43.3	39.7	53.3	54.0	57.4
Loans to the private sector (d) (e)	5.5	5.4	6.1	6.5	7.1	7.6	7.6	
Euro area ten-year bond yield	4.4	4.2	4.4	4.2	3.8	3.7	3.4	3.3
US-euro area ten-year bond spread	-0.05	-0.11	0.28	0.14	0.36	0.67	0.80	0.84
Dollar/euro exchange rate (e)	1.263	1.222	1.216	1.241	1.362	1.296	1.209	1.197
Appreciation/depreciation of the euro (e)	20.4	-3.2	-3.8	-1.7	7.8	-4.8	-11.2	-12.2
Dow Jones EURO STOXX Broad index (e)	18.1	1.9	3.7	1.5	9.9	4.3	8.9	13.0

SOURCES: Eurostat, ECB and Banco de España.

a. The information in italics does not cover a full quarter.

b. Information available up to 19 July 2005.

c. Quarter-on-quarter growth forecasts.

d. Year-on-year growth.

e. End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

tries posted a growth rate lower than or similar to that of the previous quarter. As mentioned, the significant acceleration in activity in Germany, which grew by 1% in quarter-on-quarter terms (-0.1% in 2004 Q4), includes an upward bias related to a statistical over-adjustment for working days in the final quarter of 2004. Component by component, this recovery was due, as in the rest of the area as a whole, to the notable reduction in imports which, along with the buoyancy of exports, meant that the contribution of the net external balance recovered to 1.6 pp, while all the internal demand components fell. French GDP slowed significantly owing to the loss of steam in private and government consumption and in exports. And Italy once again posted a negative rate of change in output (-0.5%) further to the zero contribution of domestic demand and the negative contribution of external demand, insofar as exports fell more than imports.

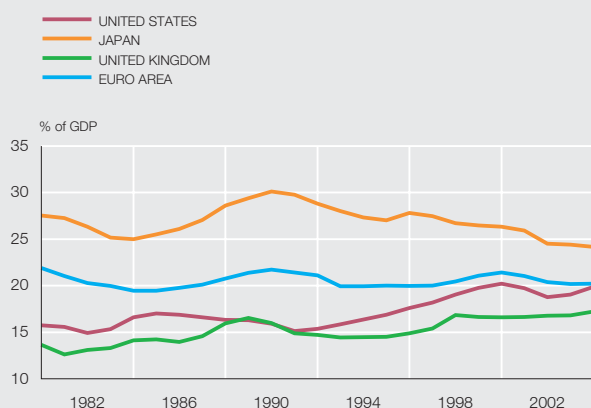
Across the branches of production, the higher growth rate of the euro area economy's value added was in response to the buoyancy of industry and of retail and wholesale trade, as the behaviour of construction and agriculture was less expansionary, and growth in the other industries remained moderate. As to the labour market there was a 0.2% increase in employment, the same as in the two previous quarters, which made for a slight recovery in year-on-year terms. This improvement, along with the year-on-year slowdown in output in 2005 Q1, resulted in a smaller increase in apparent labour productivity. Also on National Accounts data, unit labour costs increased by almost half a point in Q1 to 1.6%, the result both of the higher growth of compensation per employee (2%, compared with 1.8% the previous quarter) and of the diminished buoyancy of productivity. Nonetheless, the rise in unit labour costs was lower

Gross fixed capital formation (GFCF) is an especially important component of gross domestic product. This is true both in the short run, owing to its high volatility and procyclicality, and in the long run, when the path of GDP is heavily dependent on the economy's capital stock. The first chart shows that the weight of GFCF in euro area GDP has been highly stable over the last few decades, fluctuating at around 20%. This contrasts with the behaviour of this variable in the other main economies. In the United States and in the United Kingdom, GFCF has displayed an upward trend, with its weight in output increasing by some four percentage points since the beginning of the 1980s. In Japan, by contrast, following a major boom in the 1980s, its importance has been progressively falling.

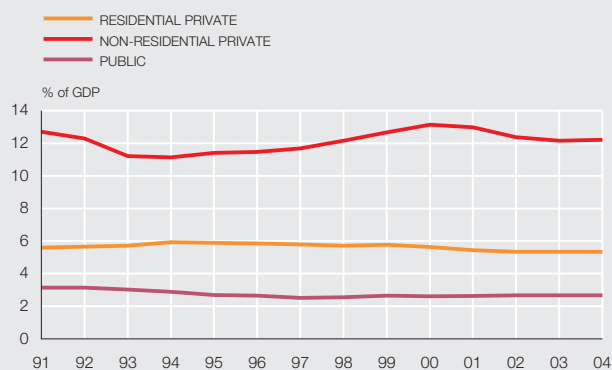
GFCF comprises the acquisition of goods of a very disparate nature and is the result of spending decisions by all the institutional sectors (companies, households and general government) that, in turn, have highly diverse determinants. Accordingly, it is useful to analyse the relative importance and the cyclical behaviour of the various components of GFCF, when broken down by type of goods and by type of investor. By product type, three sub-aggregates may be identified: capital equipment (which includes machinery and transport and IT

equipment); construction, which breaks down into dwellings and other construction (including public works and buildings and structures acquired by companies); and other. This latter component is more heterogeneous, ranging from trees and livestock to computer software, patents and entertainment, literary or artistic originals. As an illustration of the divergences seen in the behaviour of the three groups, in 2005 Q1 the growth rate of GFCF in the euro area was -0.4%, the result of a fall in construction of 1.3% that was partially offset by increases in investment in capital equipment and other goods of 0.5% and 0.8%, respectively. The second chart shows various distinguishing features of the behaviour of these three components. First, the cyclical behaviour of GFCF can be seen to be determined mainly by the behaviour of investment in capital equipment, whose weight in GDP has fluctuated at around 8%. The cyclical variability of the other two components of GFCF is lower and both seem to display trends, albeit with different signs. Construction has progressively declined in importance, its share in GDP falling by almost two percentage points between 1991 and 2004, to 10%. This reduction stemmed from both the dwellings and the other construction components. By contrast, other investment has progressively increased in importance, to 2.5% of GDP in 2004. Among other fac-

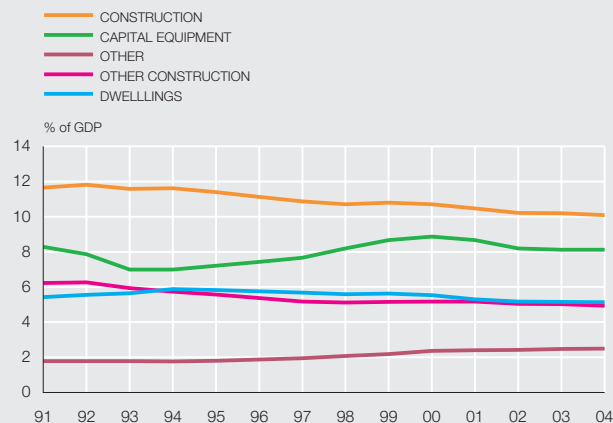
### 1. GROSS FIXED CAPITAL FORMATION



### 3. GFCF: BY SECTOR



### 2. GFCF: BY TYPE OF GOODS



### 4. GFCF: RECENT BEHAVIOUR



SOURCES: Eurostat and OECD

- a. Contribution to change in GFCF in each period.  
b. Percentage change in the periods indicated.



tors, this may be the result of the growing importance in the investment decisions of companies of certain intangible fixed assets, such as computer programs and patents.

When considering the classification of GFCF by investor sector, public and private investment are distinguished, with the latter being divided into residential (acquisition of dwellings by households) and non-residential (company investment). The third chart shows how, in line with the above comments regarding the acquisition of capital equipment, non-residential private investment (12.2% of GDP) displays the highest degree of volatility over the cycle. Meanwhile, the weight of residential private investment (5.3% of GDP), which would correspond to the item dwellings in the second chart, increased slightly at the beginning of the 1990s, as a consequence of the German housebuilding boom that followed reunification. Since then, it has fallen progressively, again in line with the negative behaviour of this component in Germany, despite its growing importance in coun-

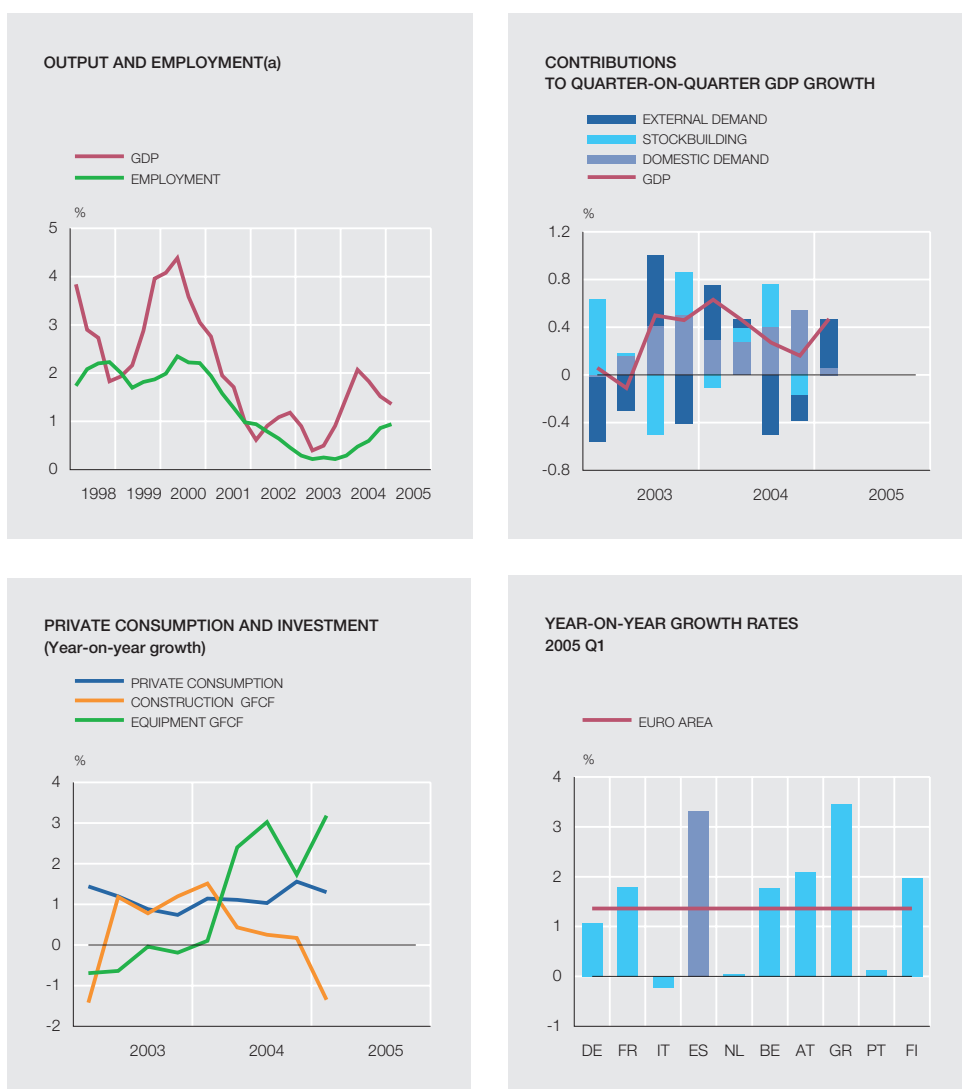
tries such as Spain. Finally, public investment is on a slightly downward trend, fluctuating at around 3% of GDP.

The fourth chart shows GFCF and its components (classified by type of goods and by sector) during the recent cyclical downturn and upturn. Between 2001 Q1 and 2003 Q2, GFCF in the euro area fell by about 4%, and then increased by somewhat more than 2% between that latter quarter and 2005 Q1. By product, the component making the largest contribution both to the reduction and to the recovery in GFCF was investment in capital equipment. Other investment, by contrast, made a positive contribution to the growth of GFCF in both phases, while the behaviour of construction was the opposite, with slight falls in both periods. In terms of the classification by sector, it was non-residential private investment that caused the movements in GFCF, while both public and residential private investment increased constantly, although moderately, in both phases.

than the increase in the GDP deflator (1.8% year-on-year), meaning business margins widened again in this period (see Chart 11).

The latest information on economic developments in Q2 points to a moderation of GDP growth in the euro area. As far as the supply-side indicators are concerned, the industrial production index (excluding construction) posted a very small increase in the April-May period compared with Q1. Both the European Commission's (EC) business confidence index and Reuters manufacturing PMI index worsened in relation to the average of the previous quarter. However, both indicators showed an improving profile in June, although the second of them was still below the level of 50, a value consistent with a contraction in activity (see Chart 9). The EC confidence indicator for construction also declined. In relation to activity in the services branch, the EC indicator worsened, and the PMI index held constant at a level of over 50 points, indicative of an expansion in the sector (see Table 1). As to employment, the surveys-based indicators available show a deterioration in Q2 in industry, and an unchanged situation in services and construction (see Chart 10). Despite the stability of the rate of employment generation, the unemployment rate has risen slightly and stood in May at 8.9%, 0.1 pp up on Q1.

From the demand standpoint, the indicators available point to the sluggishness of private consumption and investment in Q2. The pick-up in retail sales in May was unable to offset in full the decline the previous month, meaning that the average growth of the two months in relation to Q1 continued to post negative values. Further, both consumer and retail confidence worsened on Q1, with both reaching one of the lowest levels for the past year in June (see Chart 9). Finally, new car registrations improved slightly in Q2 compared with Q1, although their growth slowed in year-on-year terms. Turning to the demand for capital goods, and according to the half-yearly manufacturing investment survey conducted by the EC in April, industrial corporations anticipate growth in investment of 1% for 2005, a downward revision from the figure of 2% foreseen in November 2004. This estimate is, in any event, higher than the final figure for last year (-2%). As regards the foreseeable course of investment in Q2, both the assessment of industrial orders and the degree of capacity utilisation in the quarterly survey worsened in this period. Lastly, in the external sector, export data from the balance of payments for April and

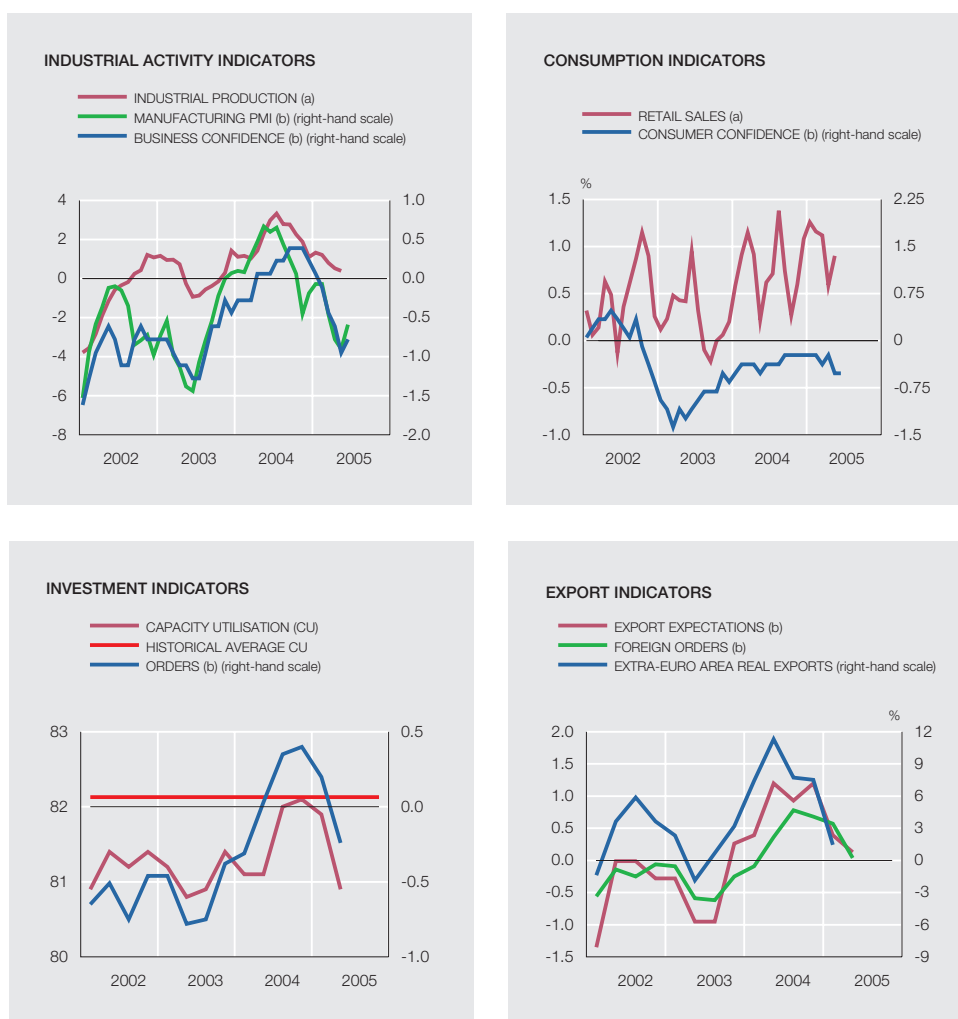


Sources: Eurostat and national statistics.

a. Year-on-year rates of change.

May point to a slight improvement. Nonetheless, both the quarterly indicator of export expectations in industry compiled by the EC and the monthly indicator of the assessment of foreign orders trended unfavourably during 2005 Q2. Finally, on the basis of the business confidence survey, stockbuilding has continued to increase above the desired levels.

In sum, the information available on economic developments in the euro area in Q2 points on the whole to a moderation in GDP growth in this period, which the European Commission foresees will stand in a range of 0.1%-0.5% (see Table 1). This slowdown would be due only in part to the reversal of the calendar effects affecting the Q1 figures, and it would reflect weak growth in most of the components. Nonetheless, domestic demand will foreseeably post a higher contribution than that in Q1, insofar as the strongly negative effect of investment in construction is corrected and the other components maintain their rate of increase. Despite the rise in exports, in line with the improvement in export markets, the pick-up in imports as a result of the improvement in final demand will probably be manifest in a lower contribution of external demand. In subsequent quarters, the favourable monetary and financial conditions in place, along with relatively high growth in world trade and the depreciation of the euro, should

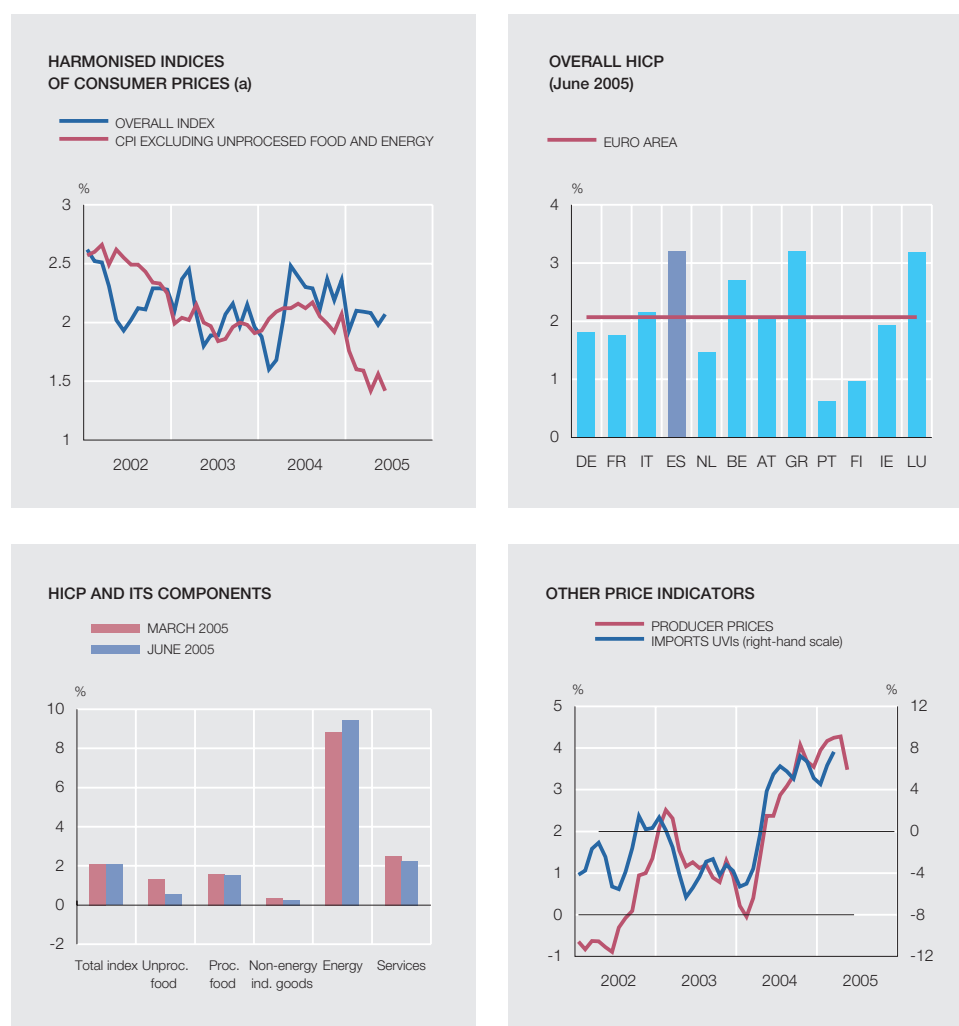


SOURCES: Eurostat and European Commission.

- a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.  
 b. Normalised data.

ultimately provide for the start of a sustained recovery in economic activity, in line with most of the forecasts available. However, behind this relatively favourable scenario for future economic developments in the euro area, there are essentially downside risks relating to the persistence of high oil prices, the possibility of a sharp correction in the current global imbalances, and the low levels of consumer and business confidence prevailing in the area.

The inflation indicators were generally relatively stable in Q2. As a result, the growth of the harmonised index of consumer prices (HICP) stood at 2.1% year-on-year in June, unchanged on the March figure (see Chart 10). Behind this performance of the aggregate index lies the slowdown in services and unprocessed food prices, and the higher rate of increase of energy goods. Consequently, the 12-month rate of change of the index that strips out these two types of goods held at levels that were generally below those in Q1, standing at 1.4% in June. As regards the country-by-country trend of the HICP, the divergences between the maximum and minimum rates of inflation are somewhat more than two percentage points (see Chart 10). The 12-month growth rate of producer prices in May was 3.5%, compared with 4.3% in March. The slowdown was due to the diminished buoyancy of the energy and intermediate goods components, since the rate of expansion of the other components scarcely changed.



SOURCES: Eurostat and European Central Bank.

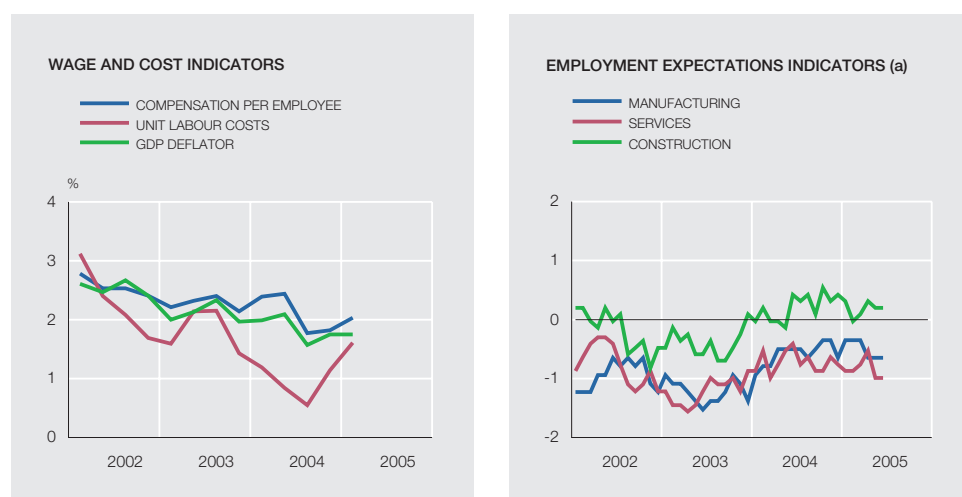
a. There is a break in January 2002 when the series was rebased to 2001.

Despite the moderation of the most stable core of inflation in Q2, the short-term outlook for prices has worsened somewhat. The progressive pass-through of the recent depreciation of the euro to the prices of the less volatile components and the fact oil prices will foreseeably hold at a high level, as futures market prices anticipate, may delay the attainment of an inflation rate below 2% over the rest of the year. Looking to the medium term, inflationary expectations will remain more contained, contributing to which will be wage restraint against a background of modest growth, a sluggish labour market and strong international competition. The biggest factor of uncertainty in respect of future inflation stems from oil prices and the influence they may exert on the future behaviour of wage demands.

According to the estimates published by the ECB, the balance of payments deficit on current account in the period to April 2005 amounted to €6.7 billion, compared with the surplus of €14.4 billion in the same period a year earlier. This reduction was essentially the result of the lower surplus on the balance of goods, which dipped from €38 billion in the January-April 2004 period to €18 billion in 2005, further to the bigger increase in imports than in exports. Bearing in mind, moreover, that there was a net outflow of capital in the form of direct and portfolio investment in the same period, the basic balance posted a deficit of €40.9 billion.

**EURO AREA. WAGE AND EMPLOYMENT INDICATORS**  
Year-on-year percentage changes

CHART 11



SOURCES: Eurostat and European Central Bank.

a. Expectations based on European Commission sentiment indicators. Normalised data.

**GENERAL GOVERNMENT BUDGET BALANCES**  
**OF EURO AREA COUNTRIES (a)**

TABLE 2

% of GDP	2002	2003	2004	2004 (b)	2005 (c)	2005 (d)
Belgium	0.1	0.4	0.1	0.0	-0.2	0.0
Germany	-3.7	-3.8	-3.7	-3.3	-3.3	-3.0
Greece	-4.1	-5.2	-6.1	-1.2	-4.5	-3.7
Spain	-0.3	0.3	-0.3	0.0	0.0	0.1
France	-3.2	-4.2	-3.7	-3.6	-3.0	-2.9
Ireland	-0.4	0.2	1.3	-1.1	-0.6	-0.8
Italy	-2.6	-2.9	-3.2	-2.2	-3.6	-2.7
Luxembourg	2.3	0.5	-1.1	-1.8	-1.5	-1.0
Netherlands	-1.9	-3.2	-2.5	-2.3	-2.0	-2.6
Austria	-0.2	-1.1	-1.3	-0.7	-2.0	-1.9
Portugal	-2.7	-2.9	-2.9	-2.8	-4.9	-6.2
Finland	4.3	2.5	2.1	1.7	1.7	1.8
MEMORANDUM ITEM: euro area						
Primary balance	1.2	0.6	0.6		0.6	
Total balance	-2.4	-2.8	-2.7	-2.3	-2.6	-2.3
Public debt	69.5	70.8	71.3	69.8	71.7	70.6

SOURCES: European Commission, national stability programmes and Banco de España.

- a. As a percentage of GDP. Proceeds from the sale of UMTS licences not included. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
- b. Targets of the stability programmes presented between November 2003 and January 2004.
- c. European Commission forecasts (spring 2005).
- d. Targets of the stability programmes presented between November 2004 and June 2005.



SOURCES: European Central Bank and Banco de España.

a. Estimated using swap market data.

b. Estimated using Euribor data.

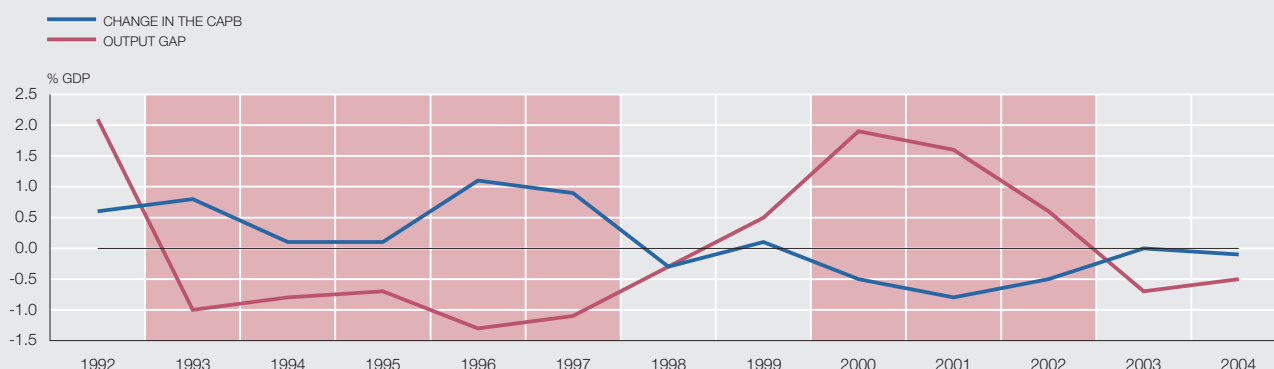
In the fiscal policy realm, the course of public finances in the euro area countries indicates that most members will not meet in 2005 the budgetary targets proposed in their stability programmes. In accordance with the European Commission's spring 2005 estimate, the euro area budget deficit will stand at 2.6% of GDP, a higher figure than the aggregation of the Member States' programmed budget deficits, and only 0.1 pp down on the previous year (see Table 2). Moreover, the European Commission's estimate of public debt as a proportion of GDP for 2005 is 71.7%, also above the figure implicit in the stability programmes. The lack of fiscal consolidation in 2005 would be in line with that observed in recent years, when the Stability and Growth Pact did not appear to have the same disciplining capacity as the Maastricht convergence criteria (see Box 2). The European Commission's forecasts also infer that, in the absence of additional measures, four euro area countries – Germany, Greece, Italy and Portugal – will have an excessive deficit in 2005. Further, based on Commission forecasts, the cyclically adjusted primary balance will be virtually unchanged in 2005 in relation to the previous year, whereby no fiscal policy impulse on growth is expected.

The ability of fiscal policy to offset fluctuations in economic activity has two facets. First, various budget headings (basically on the revenue side) are affected almost immediately by the business cycle, in such a way that they help to counter demand fluctuations (these are known as “automatic stabilisers”). Second, the authorities may decide to introduce discretionary fiscal measures of an expansionary (contractionary) nature when activity is weak (strong). The advantage of allowing the former mechanism to operate freely is commonly recognised, given that its impact on the economy is immediate and that its sign also changes automatically when the cyclical circumstances change. However, the advantage of using discretionary fiscal policy to stabilise cyclical fluctuations is more controversial, for two types of reasons. First, because there is a considerable lag from the time at which the change in the business cycle is perceived until the measures adopted to counter this change begin to take effect, so that countercyclical action may end up being procyclical. Second, because when expansionary measures are taken to combat a slowdown, with the intention that they should be temporary, they often end up becoming permanent, so that an upward bias is introduced into budget deficits. At all events, an obvious requirement that these policies should satisfy is that their use should be truly countercyclical.

This latter basic condition has not been satisfied by the discretionary fiscal policies applied in the euro area countries over the last decade. The adjoining chart depicts the change in the cyclically adjusted primary balance (as a percentage of GDP) and the output gap for the area as a whole in the period 1992-2004. An improvement in the cyclically adjusted primary balance indicates a contractionary discretionary fiscal policy stance, and vice versa. At the same time, an increase (reduction) in the output gap can be identified with an expanding (slowing) economy. Stabilising or countercyclical discretionary fiscal policies are those that involve an improvement in the cyclically adjusted primary balance during upturns and a deterioration during downturns. Accordingly, when a discretionary policy is stabilising, the changes in the output gap and in the cyclically adjusted primary balance will have the same sign. In this sense, the discretionary fiscal policies applied in the euro area since 1992 (see the areas shaded pink in the chart) have been destabilising during the periods 1993-1997 and 2000-2002, since the changes in these two variables had the opposite signs during those years.

Using the 156 observations obtained by taking the annual changes in these two variables for each country of the euro area in each of these 13 years, the table shows the proportion of occasions on which the

#### 1. EURO AREA: OUTPUT GAP AND CYCLICALLY ADJUSTED PRIMARY BALANCE (CAPB)



#### 2. PROPORTION OF OCCASIONS ON WHICH FISCAL POLICY HAS BEEN STABILISING OR DESTABILISING

	$\Delta \text{GAP} > 0$ ("expansion")		$\Delta \text{GAP} < 0$ ("recession")	
	$\Delta \text{CAPB} < 0$ (procyclical FP)	$\Delta \text{CAPB} > 0$ (countercyclical FP)	$\Delta \text{CAPB} > 0$ (procyclical FP)	$\Delta \text{CAPB} < 0$ (countercyclical FP)
<b>PERCENTAGES OF EXPANSIONS AND RECESSIONS IN EACH PERIOD</b> (in brackets, absolute number of observations)				
1992 - 2004	61.8% (47)	38.2% (29)	60.0% (48)	40.0% (32)
1992 - 1997	46.4% (13)	53.6% (15)	70.5% (31)	29.5% (13)
1998 - 2004	70.8% (34)	29.2% (14)	47.2% (17)	52.8% (19)
<b>ELASTICITY: <math>\Delta \text{CAPB}</math> for each pp of <math>\Delta \text{GAP}</math></b>				
1992 - 2004	-0.74	0.97	-0.86	0.72
1992 - 1997	-0.53	1.78	-0.96	0.42
1998 - 2004	-0.85	0.49	-0.66	1.13

SOURCE: European Commission.

fiscal policy was stabilising (or countercyclical) and destabilising (or procyclical), distinguishing between upswings and downswings. During the period as a whole, discretionary fiscal policy was expansionary in somewhat more than 60% of cases when the economy was expanding, and contractionary in a similar proportion of the cases of slowing activity, which means that discretionary fiscal policy has tended to be destabilising over the time horizon considered. When these data are broken down into two sub-periods (up to 1997 and thereafter), it can be seen that they behaved very differently in each. Thus, while fiscal policy, until 1997, was mostly countercyclical during expansions and procyclical during recessions, from 1998 its behaviour was precisely the opposite. In sum, contractionary discretionary fiscal policies predominate in the first period (improvements in the cyclically adjusted primary balance), while expansionary ones predominate in the second (deteriorations in this variable).

These results may partly be explained by the abovementioned lags with which discretionary fiscal measures operate. As a result of these lags, the effects of the measures may occur when the cyclical conditions that gave rise to their adoption have already changed. However, in the light of the data presented, it may be plausibly concluded that the discretionary actions were not primarily guided by considerations of macroeconomic stabilisation, but by reasons of another kind. More specifically, the magnitude of the incentives to conduct disciplined fiscal policies in these two periods was probably very different. At the

beginning of the 1990s, strongly deteriorating public finances gave rise to the perception that it was urgent to take decisive action to avoid the risk of unsustainable general government balances. Moreover, compliance with the convergence criteria for access to Stage Three of EMU operated, during these years, as a powerful spur to deficit correction. By contrast, when Monetary Union had been established, this incentive disappeared, being replaced by another (the Stability and Growth Pact, SGP) whose power to discipline governments has proved to be less strong. Moreover, during the years around the turn of the century, the improvement in the underlying budget position led to the erroneous perception that tax reductions could be made to improve economies' supply conditions, without the adoption of other measures to offset the impact on the balances of the reduction in revenues.

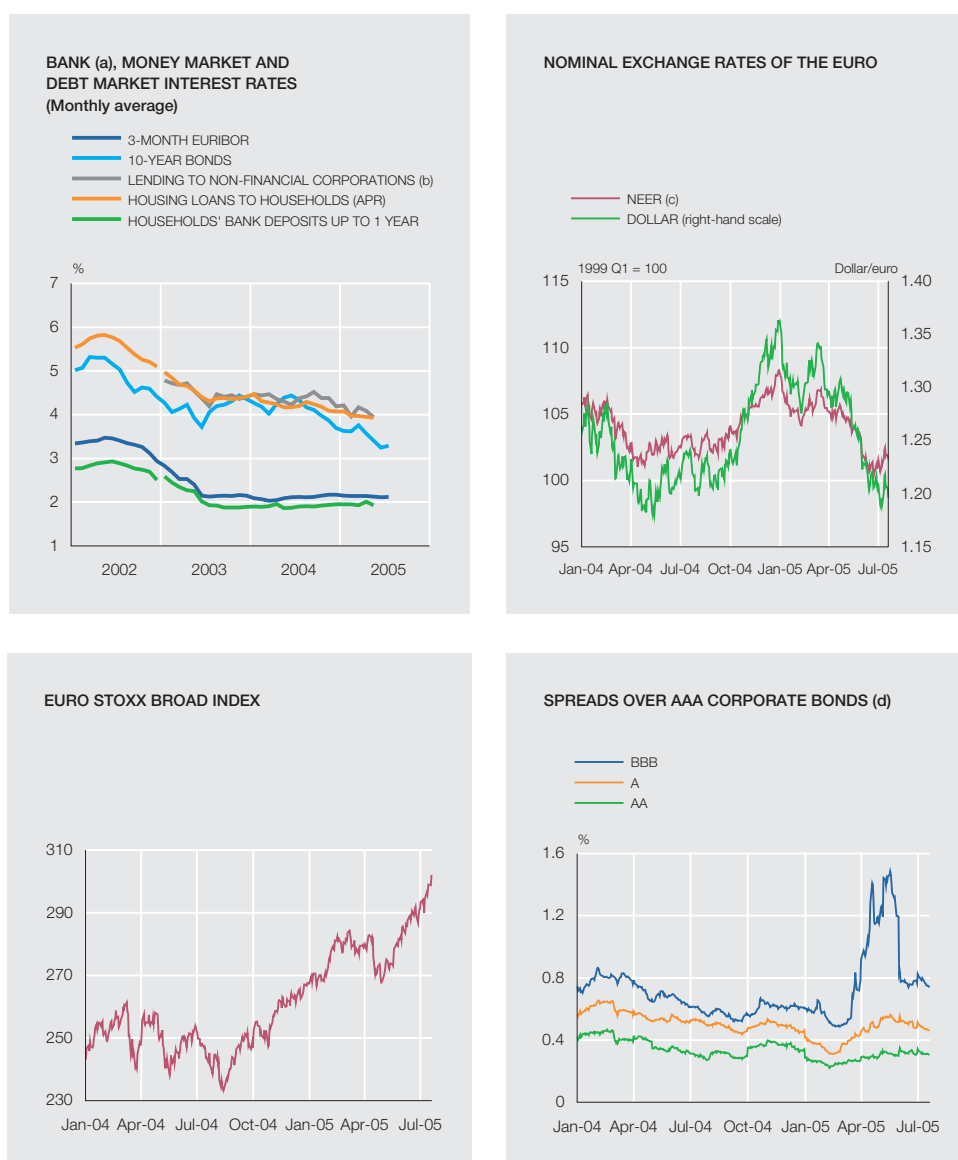
On the basis of the data presented, we cannot conclude unequivocally that discretionary fiscal policy is unable to stabilise activity, but it has been observed not to have done so in practice. At the same time, the data do not support the argument that the SGP has led to a reduction in the stabilising capacity of fiscal policy, which was already very low. As a corollary, it is inferred from the analysis that, in future, the SGP will need to be applied more rigorously for two reasons: to secure the consolidation of general government finances and to generate sufficient leeway to allow automatic stabilisers (an instrument to offset cyclical fluctuations whose use is less controversial) to operate freely.

In the course of 2005 Q2, Excessive Deficit Procedures (EDP) were initiated against Italy and Portugal. In Italy's case, the revision of the deficit to 3.2% in 2004, and the forecast that this variable would be clearly above 3% in 2005 and 2006, triggered the opening of the EDP by the Commission in June, a move subsequently supported by the ECOFIN on 12 July. In Portugal, the June update of the Stability Programme estimates a budget deficit of 6.8% for 2005, which would not dip below 3% until 2008. The Commission has issued an opinion under the provisions of article 104.5 of the Treaty in which it concludes that there is an excessive deficit in Portugal. At present, a pronouncement by ECOFIN is pending. Regarding the other EDP initiated, in Germany the Commission foresees a deficit of 3.3% for 2005; however, according to the German government the deficit this year will be 3.7% of GDP and will remain above 3% until 2007. In France, the risk that the budget deficit will exceed the figure of 3% envisaged by the Commission in 2005 is high, since it is intended to increase public investment in infrastructure and to introduce a series of measures on employment contracts, which might increase public spending. The Commission has concluded that, in connection with the EDP initiated against Greece in 2004, the measures needed to eliminate the excessive deficit in 2006, by the latest, are being taken. Finally, in the Netherlands, the government managed to bring the budget deficit below 3% of GDP in 2004, meaning the EDP initiated against this country will be derogated.

### 3.2 Monetary and financial developments

At its meetings held since March this year, the ECB Governing Council considered that the monetary policy stance continued to be in line with the maintenance of price stability in the medium term, while it was in step with the outlook under which the current phase of slack economic activity would be gradually left behind. Accordingly, the interest rates on the main



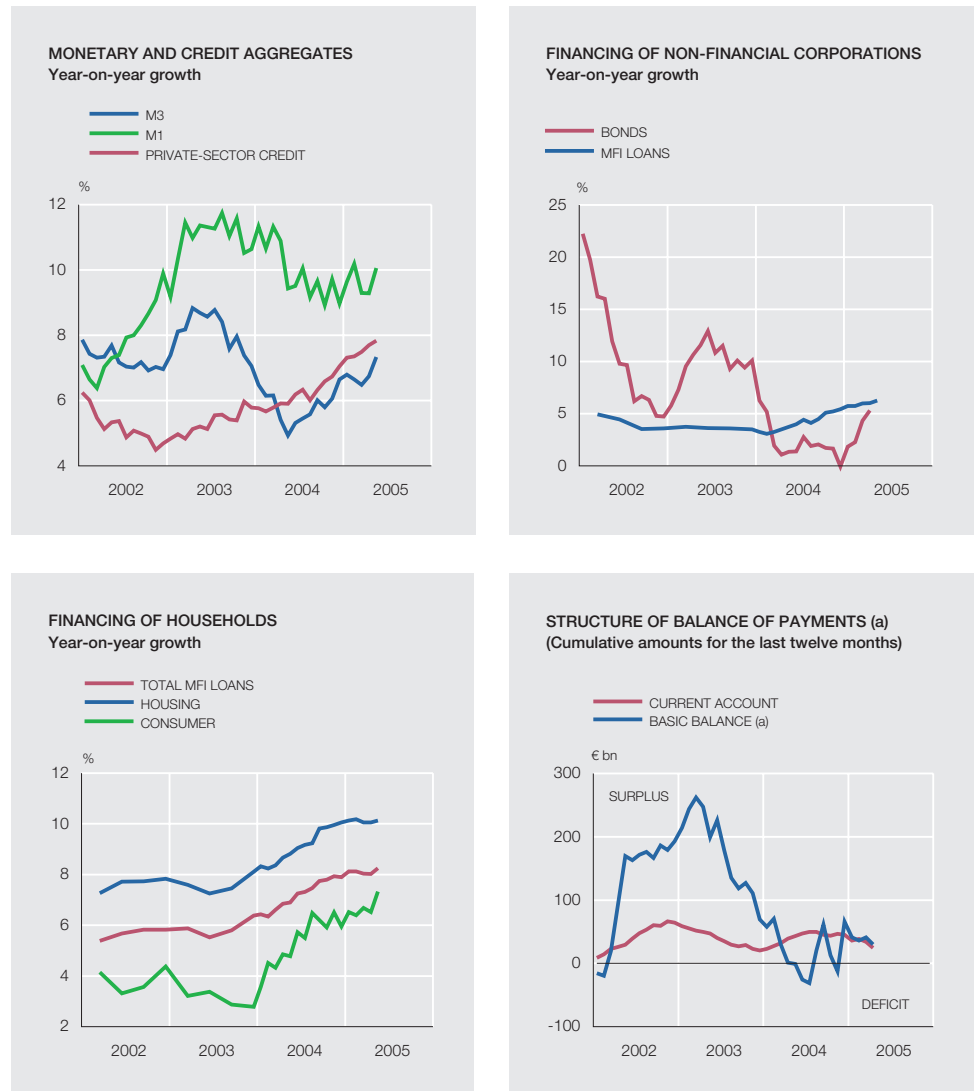


SOURCES: Banco de España and European Central Bank.

- a. Data drawn from new statistics on interest rates compiled by the ECB for new business.  
 b. Interest rates over five years.  
 c. Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.  
 d. Euro-denominated bonds issued by non-financial corporations.

refinancing operations, on the deposit facility and on the marginal lending facility held at 2%, 1% and 3%%, respectively (see Chart 12).

During April, money market interest rates declined at the longer-dated terms, meaning that, in late June, the profile of the one-month yield curve did not point to movements in official rates. However, in the first fortnight of July, the slope of the curve turned positive in the longer-dated segment, reflecting a deterioration in the inflation rate outlook, as a result of the recent course of oil prices (see Chart 12). On the debt markets, ten-year yields continued on the declining trend initiated in mid-2004, reaching their lowest level (around 3.2%) since the introduction of the euro in 1999 (see Chart 13). The decline in bond yields in the euro area appears to reflect the deterioration in economic growth expectations. As long-term debt yields in the United States have fallen by a lesser extent, US/euro area long-term



SOURCES: Banco de España and European Central Bank.

a. The basic balance is approximated by the sum of the balance on current account and direct and portfolio investment.

spreads have widened slightly in recent months, to 87 bp in July. On the information available to May, the interest rates applied by credit institutions to their lending and deposit operations held stable, generally, although the interest rates on loans granted to households for house purchases continued to move on a slightly declining trend, standing at 4% in May.

On the currency markets, the exchange rate of the euro continued on a depreciating trend in Q2 after the process was temporarily interrupted in March. In particular, the depreciation against the dollar was closely linked to the favourable news on the US economy which, along with the Federal Reserve interest rate rise and the widening of the differential with the euro area, was conducive to the appreciation of the US currency. Furthermore, the French and Dutch rejection of the European constitution added more downward pressure on the euro. As a result, the euro has depreciated by around 7.2% against the dollar since April. The euro also fell against the yen in Q2, although this trend has reversed to date in July. Sterling has vacillated against the euro in recent months, although the terrorist attacks accentuated slightly the

appreciation of the euro seen from early July. In nominal effective terms, the euro has depreciated by 3.3% since April (see Chart 13).

On the euro area equity markets, the recovery continued in May and June following the interruption in April. Low interest rates, favourable corporate results and the depreciation of the euro meant that the cumulative gain in relation to 2004 was higher than 10%. The terrorist attacks in London did not greatly impact the euro area stock markets, prompting only a one-off slide on 7 July. The behaviour of the different sectors was far from uniform in this period. Prices rose more strongly in the energy sector, as a result of higher oil prices, and prices in the technological, industrial and financial sectors followed suit. The volatility on the equity markets, after a slight rise in late April, saw a resumption of a declining trend in the following months.

In April and May, the rate of increase of the M3 monetary aggregate intensified, climbing to 7.3% in May, 0.8 pp up on March 2005 (see Chart 14). The acceleration was extensive to most of its components, but it was particularly concentrated in its less liquid instruments. The year-on-year growth rate of credit to the private sector has become progressively more buoyant since the start of the year, rising to 7.8% in May. Under loans, those granted to non-financial corporations quickened, while the rate of expansion of those extended to households held stable. Under the latter, loans for house purchase – the main component of bank financing to households – have held at a growth rate of around 10% since the beginning of the year, while the increase in consumer loans stepped up to a rate of 7.3% year-on-year in May. Among the larger countries, credit in Germany and Italy increased in relation to March, while it lost momentum in France. In Italy, despite the sluggishness of activity, private-sector loans both to households and corporations continued to climb at a rate outpacing that of the euro area average. In Spain, loans to non-financial corporations and households have continued to show fairly high growth rates, far higher than those of the euro area as a whole.

## 4 The Spanish economy

In May, the INE published the first data for the new Spanish National Accounts, with base year 2000 (CNE 2000), relating to the period 2000-2004. The main changes and implications of these data were analysed in detail in the June issue of the *Boletín Económico*. In general, the CNE 2000 data have raised the rate of growth of economic activity in recent years with respect to the base year 1995 estimates, also modifying the growth profile of some macroeconomic aggregates. In particular, these changes accentuated some features of the growth pattern of the Spanish economy in 2004, by estimating greater dynamism of private consumption and investment in construction, along with a smaller stimulus from investment in equipment and exports. The growth of GDP in that year was 3.1%, 0.4 percentage points higher than the CNE 1995 estimate. The INE has also published the new Quarterly National Accounts (QNA) series, including an estimate of 2005 Q1, which puts the rate of growth of activity in that period at 3.3%, thus prolonging the path of smooth acceleration that began in 2004 Q1.

The data available for 2005 Q2 suggest that GDP continued to accelerate, to reach an estimated year-on-year rate of 3.4%. As in recent years, this increase in activity was driven by the strength of domestic demand, which continued to expand at rates close to 5.5%, while external demand, in net terms, continued to make a sizeable negative contribution to GDP, although it was somewhat smaller than in Q1 (see Chart 15). As in Q1, private consumption and investment in capital equipment were the most dynamic components of domestic demand, while exports and imports displayed somewhat higher rates of expansion than in the previous quarter.

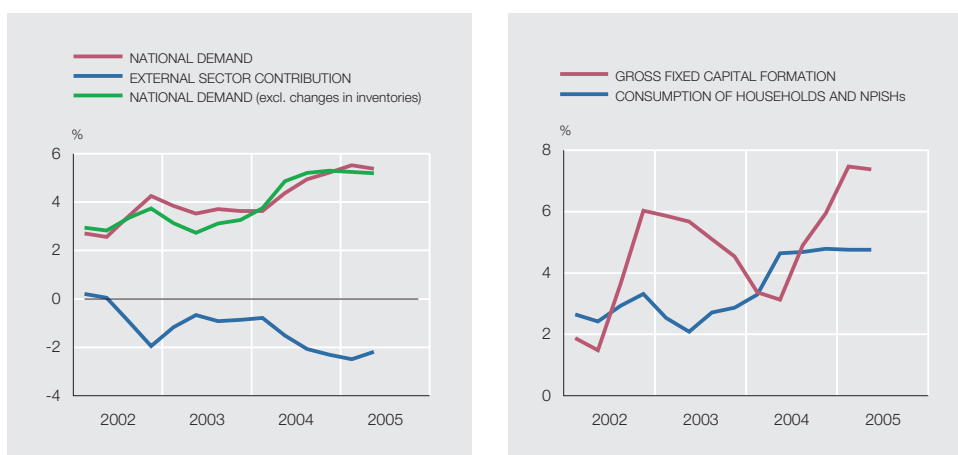
By sector, construction is estimated to have remained the most vigorous productive branch in Q2, with a similar year-on-year growth rate as in the period January-March (5.6%), while market services accelerated. Manufacturing continued to grow at moderate rates, of below 1%, and agriculture was the only branch that underwent a slowdown, similar to the one in Q1 (-1.8%). The employment indicators show continued expansion, although in some cases they have been distorted by the effects of the legalisation of immigrants that took place between February and May. This process has given rise to strong growth in new Social Security registrations. However, when this information is adjusted for the anticipated effects of the legalisation, new registrations still accelerated slightly in Q2, to a rate of somewhat more than 3%. The Spanish Labour Force Survey (EPA) data for Q2 also confirm the greater intensity of employment creation in that period. This means that the growth rate of apparent labour productivity must have been very low and close to its level in the last few quarters.

Muted productivity growth and the estimated pick-up in compensation per employee in Q2 would have led to an acceleration in unit labour costs, to rates of 3%. Despite this and rising energy prices, inflation, as measured by the CPI, fell slightly over the period, from 3.4% in March to 3.1% in June.

### 4.1 Demand

In 2005 Q1, Spanish households' final consumption expenditure grew at the high rate of 4.8% year-on-year, similar to the rate at the end of 2004. The latest information indicates that consumption conserved this strength in Q2, with a rate of expansion very close to that of Q1. This buoyancy is sustained by the favourable trend in household disposable income, by the rise in real net wealth in recent years and by the maintenance of generous financial conditions

Various indicators suggest that household consumption continued to grow at a high rate in Q2 (see Chart 16). All the components of the composite indicator of spending on consumer goods



SOURCES: INE and Banco de España.

a. Year-on-year percentage change based on seasonally adjusted series.

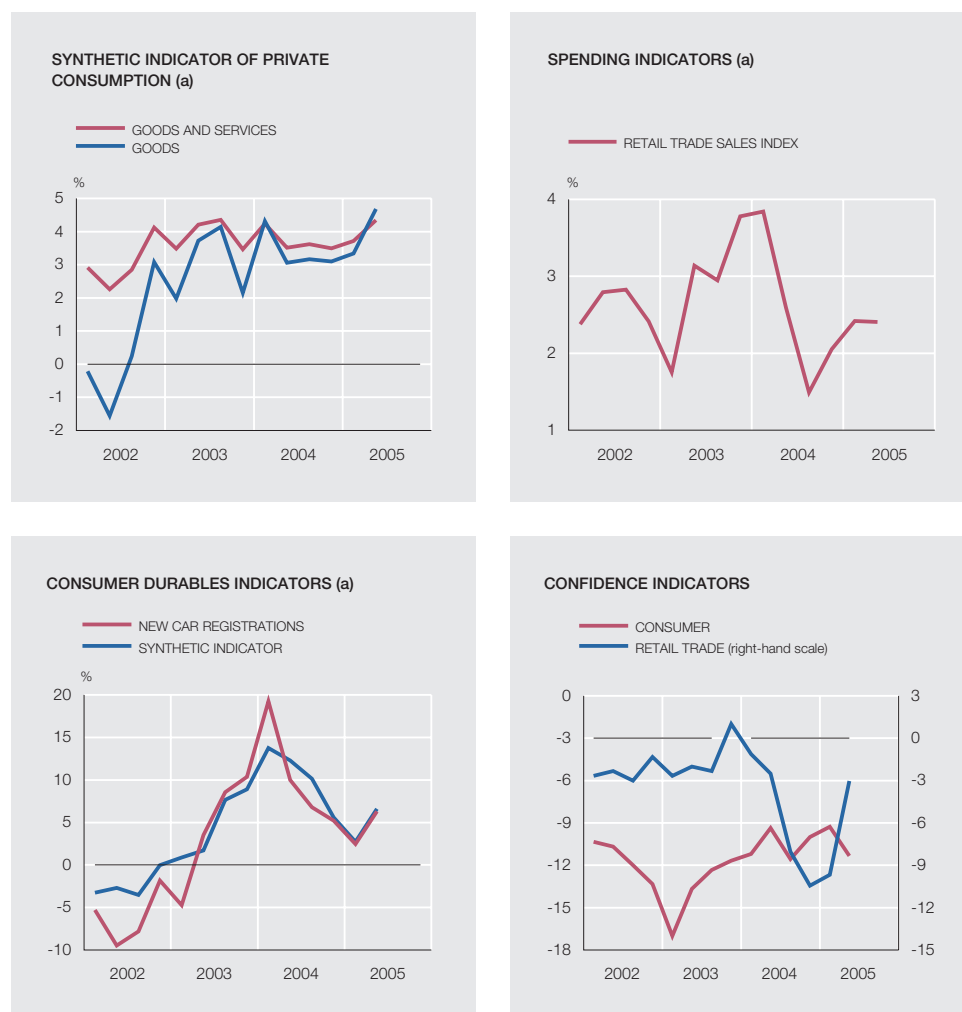
and services accelerated, while the trend growth rate of the index of total retail sales stabilised in this period. The retail confidence indicator, which improved significantly in 2005 Q2, and new car registrations point in the same direction. The consumer confidence indicator, however, declined, owing to less optimism about the general economic situation and employment.

The growth of employment and in compensation per employee continued to boost the growth of real disposable income. The higher estimated growth in compensation per employee, relative to 2004, is partly a reflection of the triggering of last year's indexation clauses. In any case, these favourable effects on income must have been offset, at least partially, by a smaller contribution from net general government transfers, as a consequence of the end of the impact of the latest fiscal reform and of the slowdown in social benefits, as well as of the strong rise in government revenues. Meanwhile, household wealth continued to grow at a high rate, driven by the rise in property prices and the increase in their net financial wealth, which was assisted by the increase in share prices since end-2004.

In 2005 Q1, general government final consumption decelerated, although its year-on-year rate remained high (6%, in real terms). In accordance with the still incomplete State budget outturn data for Q2, the slowdown continued in that period.

The sharp acceleration in investment in capital equipment at the end of 2004 continued at the beginning of 2005. The year-on-year growth rate in Q1 was 10.5%, up 3.2 percentage points from 2004 Q4. The information available suggests that this buoyancy extended into Q2 (see Chart 17). On the basis of incomplete information for Q2, the indicator of apparent investment in capital equipment increased at similar rates to those in Q1, basically as a result of the extraordinary vigour of the imports of such goods, while national production showed some slackness. In this respect, the business confidence indicator for the sector producing capital equipment continued to deteriorate in April and May, as in Q1. Capacity utilisation held at the 80% level it reached in Q1, the highest for the last four years, although the number of firms that considered their capacity excessive continued to rise.

The buoyancy of investment in capital equipment is based on several favourable factors. According to Quarterly Central Balance Sheet Data Office estimates, there was an increase in the profitability of non-financial corporations to Q1. This positive performance by company profits

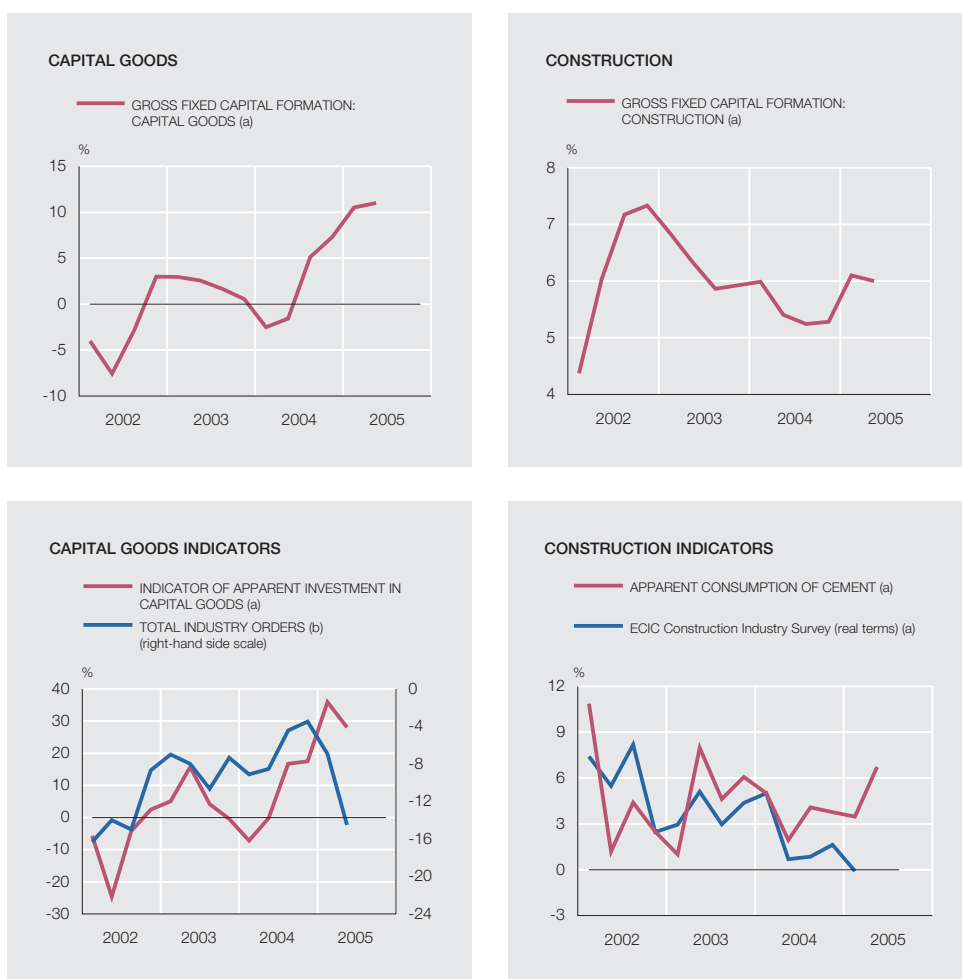


SOURCES: INE, European Commission, ANFAC and Banco de España.

a. Year-on-year percentage change based on the seasonally adjusted series.

was partly attributable to the dividends of foreign subsidiaries, which offset the higher financial and personnel expenses (arising from a larger recourse to external financing and from the increase in employment by these corporations) and the higher energy bill, due to rising oil prices. All this is conducive to the assignment of resources by Spanish firms to the financing of new investment projects. Moreover, financial conditions have continued to improve, as a consequence of the falls in long-term interest rates and the rise in stock markets, which improved significantly from end-April. However, the prolongation of this positive investment trend depends on the maintenance of demand expectations, and industrial order book data give rise to some uncertainty in this regard.

Investment in construction in 2005 Q1 grew by 6.1%, after rates of less than 5.5% were recorded during most of 2004. In the light of the latest conjunctural information, it is estimated that this buoyancy was sustained in Q2. The confidence indicator was below its levels in the previous two quarters, although the assessment remained more positive than in 2004 as a whole. Apparent cement consumption and the output of building materials tended to recover from their slackness in Q1 (owing to the incidence of Easter and the adverse weather conditions). For their part, indicators of Social Security registrations and registered unemployment were favourable in Q2, following their slight dip in Q1. The real value of the work carried out by



SOURCES: INE, European Commission, Ministerio de Fomento, OFICEMEN, Instituto Nacional de Empleo and Banco de España.

a. Year-on-year percentage change based on the seasonally adjusted series.  
b. Level of original series.

construction companies, according to the Construction Industry Survey (ECIC), also decelerated in Q1, although this indicator seems to have lost some of its informative content; over the past year it has been showing much less buoyancy than the National Accounts data.

On ECIC data, distinguishing according to the type of work, in 2005 Q1 building grew at its lowest rate for the last ten years. However, in the case of residential building, the leading indicators point to a smooth acceleration to April. The strong buoyancy of the financing of residential investment supports this assessment, while foreign property investment showed an intensifying slowdown to March. As for non-residential building, both public tenders and approvals showed a considerable recovery in 2005 Q1, which could give rise to an increase in activity in this type of work in the coming quarters. Meanwhile, the ECIC data on civil construction projects have been somewhat slack since mid-2004.

According to the latest QNA data, in 2005 Q1, net external demand subtracted 2.5 pp from GDP growth, 0.2 pp more than in the previous quarter. The slowdown in real goods and services exports intensified in this period, to reach negative year-on-year growth rates (-1.7%), while real flows of imports lost momentum (6%). This widening of the external imbalance took place in a slightly less favourable international setting than in 2004, with the slowdown in world goods



SOURCES: INE, Ministerio de Economía, Ministerio de Hacienda and Banco de España.

- a. QNA data at constant prices.  
 b. Deflated seasonally adjusted series.  
 c. Seasonally adjusted series.

and services trade since the second half of last year extending into 2005 Q1. Also, the negative gap observed since the previous year between the growth in exports and in export markets, as a consequence of the cumulative loss of competitiveness vis-à-vis the developed countries in recent years, was maintained, against a background of euro appreciation. The still-incomplete information for 2005 Q2 indicates that net external demand made a somewhat less contractionary contribution, insofar as exports recovered somewhat, buoyed by the recent depreciation of the euro, while imports retained notable vigour, given the strength of final demand.

On QNA data, goods exports weakened notably in 2005 Q1, falling by 1.7% year-on-year, following their moderate growth of 1.5% in the previous quarter (see Chart 18). Customs foreign trade figures, for April and May, show a more favourable trend in goods exports, with a real increase of 3.5%. The trend in the indicator also projects a certain recovery in the coming months, followed by stabilisation at moderate positive levels, closer to the growth rate of Spanish export markets. The recovery in exports in April and May extended both to those to the EU, which grew by 1.4% in real terms, and, especially, to those to the rest of the world, with real growth of 9%. However, between January and May, exports to the EU fell by 0.7%, against a background of acceleration in their prices. Exports to France retained positive mo-



mentum and those to Germany slowed rapidly, following their increase in Q1, while those to Italy, the United Kingdom and Benelux, and to the most recent EU entrants fell. Meanwhile, real exports to the rest of the world increased by 1.3% in the first five months of 2005. By country, sales to Japan and to the United States fell (although they have picked up since), and those to OPEC, Russia and Latin American were more dynamic.

According to QNA data, tourism receipts in 2005 Q1, fell notably, in real terms (–3.2%), possibly more sharply than the real tourism indicators. As for Q2, the April data remained negative, but in May and June overnight stays in hotels by foreigners, one of the closest indicators of real tourist spending, turned positive again. Overall, in the first five months of the year overnight stays in hotels rose by 1.1%, although stays in other regulated establishments fell by 8.2% to May. Total real spending by foreign tourists hardly increased between January and May (1.3%); despite the notable increase in tourist arrivals (5.7% in the first half), the average spending per tourist has fallen by 3.5%. This fall in average spending is attributable to the new behaviour of tourists, who tend to stay for shorter periods, use low-cost airlines, shun packages and choose unregulated accommodation. Moreover, tourism has been hampered by the loss of competitiveness of the Spanish product, compared with those offered by other countries competing in the “sun and sand” segment. As for the main markets supplying tourists, in January-June the British market grew at a moderate rate (2.1%) and the recovery in the German market continued (4.6%), while French tourist numbers surged (13.3%). At the same time, exports of non-tourism services also slowed significantly in Q1, according to the QNA, since the weakness of tourism that quarter was noted in services for the transport of merchandise and travellers (the main heading).

In 2005 Q1, according to the QNA, real goods imports decelerated by 2.5 pp with respect to the previous quarter, as a consequence of the weakness of exports and of the acceleration in their prices, although they maintained a high growth rate (7.4%). The Customs data for April and May show a pick-up in imports, with real growth of 11.3% in those two months, partly reflecting the distortion caused by the different timing of Easter, although the trend in these figures suggests that they maintained a high growth rate in 2005 Q2, supported by the spur of investment in capital equipment, the recovery in exports and the sustained growth of final consumption spending. However, the slow rate of growth in industrial production and the rise in its prices, owing to the depreciation of the euro, may have robbed them of some of their momentum. By type of product, there was a notable surge in the growth of imports of capital equipment in the first five months of the year, with a real increase of 33.2%, basically reflecting the rise in the transport equipment and machinery items. Meanwhile, real imports of consumer goods grew at a year-on-year rate of 8.3%. Notable were the buoyancy of car purchases and the strength of imports of textiles and footwear, linked to the gradual liberalisation of world trade in these products. Finally, purchases of non-energy intermediate goods reflected a large rise in this period (9.8%), despite the substantial rise in oil prices on international markets.

Lastly, in terms of the QNA, in 2005 Q1, real services imports fell (–0.7%), as a result of the weakness of purchases of non-tourism services (–5.8%), while tourism payments remained highly buoyant (24.3%), which is explained by the strength of household consumer demand and by the appreciation of the euro.

## **4.2 Output and employment**

On QNA estimates, year-on-year growth of the value added of the market economy in Q1 was 3.4%, as against 3.2% in the previous quarter, with greater strength in all branches, especially in construction (see Chart 19).

The scant rainfall this year (only 63% of historical average levels) has affected agricultural activity appreciably in recent quarters. Thus, value added continued to fall in 2005 Q1 (by –1.8%,



SOURCES: Instituto Nacional de Estadística, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

a. Year-on-year percentage rates based on seasonally adjusted series except in the case of the EPA. Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.

b. Series linked by the Directorate General Economics, Statistics and Research of the Banco de España based on the control survey carried out using the methodology applied until 2004 Q4.

according to the QNA), although slightly less sharply than in the preceding quarter. This adverse performance stemmed from arable production and, more specifically, unirrigated crops, especially corn, whose estimated production was 32% down on 2004. Fruit production, by contrast, grew at high rates, partly as a result of the low level the previous year. Finally, animal farming shows signs of a slight pick-up, both in meat and milk production, but this branch is still estimated to have continued to decline in year-on-year terms in 2005 Q2 .

In 2005 Q1, there was a slight pick-up in activity in the industrial and energy branch, in contrast to the slowdown in the second half of 2004. On QNA estimates, growth in 2005 Q1 was 1.1%, up 0.3 pp from 2004 Q4. The acceleration in activity was especially marked in energy production (up 0.9 pp to 3%), although the growth rate of the industrial branch also rose by 0.3 pp to 0.9%). The buoyancy of industrial activity stemmed from the strength of investment in capital equipment and from higher demand for non-food consumer goods, given that exports, which had been the engine of industrial production in previous quarters were very depressed. The conjunctural information relating to 2005 Q2 suggests that this branch continued to grow at a modest rate, owing to the slack demand for national capital equipment. Thus, the growth rates of both the energy and non-energy components of the industrial production index (IPI) fell over the period April-May. The index of orders received (IOR), after correcting for calendar effects and discounting the increase in prices, confirms the slow momentum of industry, although it improved somewhat in May. Finally, opinion indicators (purchasing managers' indexes and the confidence indicator) declined over the quarter. However, in June there was a significant improvement in the purchasing managers' index, which could mark a turning point in the sector, and non-energy intermediate goods imports recovered in April and May. The acceleration in goods exports in April and May, with respect to Q1, could also be a sign of a more positive outlook for this branch of activity.

Construction made a strong start to 2005, by contrast to its slowdown during 2004. On QNA estimates, the activity of this branch accelerated by 0.8 pp in 2005 Q1, to reach a year-on-year rate of 5.6%. The available conjunctural information, discussed in the previous section, indicates that activity in this branch grew at a similar rate in Q2.

The pick-up in services in 2004 Q4 did not extend into 2005 Q1, the growth rate of this sector stabilising at 4%, according to QNA estimates. However, there were some changes in its two main components. On the one hand, the growth rate of non-market services dipped by 0.2 pp to 3.6%; on the other hand activity in market services accelerated by 0.1 pp, to a growth rate of 4.2%. The pick-up in the latter component continued in 2005 Q1, according to the available conjunctural information: the composite market services indicator (ISIS) accelerated in the period April-June; the deflated services sector activity indicators (IASS) compiled by the INE gained momentum in April and May, prolonging the acceleration recorded in March; the sector confidence indicator compiled by the European Commission increased appreciably in Q2, primarily as a result of the improvement in the outlook of employers; and, finally, Social Security registrations accelerated in Q2. Among the activities included in market services, wholesale and retail trade and repairs gained momentum in the period April-June, as shown by the acceleration of car sales in this period and the improvement in the confidence indicator for this sector; transport and communications also strengthened, albeit in a contained fashion, while real estate, renting and business activities remained highly buoyant.

According to QNA information, the smooth acceleration of employment<sup>2</sup> in recent quarters extended into 2005 Q1, with year-on-year growth of 3% (up 0.1 pp on the previous quarter).

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2. In terms of full-time equivalent jobs.

Given that GDP growth in the same period showed a similar acceleration with respect to end-2004, the increase in apparent labour productivity, between January and March, held at the modest level of 0.3% (see Box 3 for a longer view of the recent behaviour of productivity). As for the conjunctural information, the main employment indicators<sup>3</sup> have generally coincided in the most recent months. Thus, a considerable upturn was seen in Social Security registrations to June. The growth rate of such registrations, in terms of end-month data, rose by more than one percentage point, to 3.9%, during Q2 (4.6% in June). Behind this notable acceleration in registrations are the effects of the legalisation of immigrants that began on 7 February, the first consequences of which have been apparent since April. However, even when those registrations attributable to this process are ignored, registrations in Q2 still displayed greater vigour than in Q1, returning to average growth of 3.1%, on end-month data. At the same time, hiring, which fell by 8.8% in Q1, rebounded even higher in Q2 (with an increase of 10%), so that in the first six months of the year it rose modestly with respect to the same period of the previous year. Finally, EPA (Spanish Labour Force Survey) data for Q2 indicate that employment remained highly buoyant in this period, with a net creation of 402,300 jobs. When this figure is corrected for the impact of the methodological changes introduced in 2005 Q1, the year-on-year change in employment was 5% (5.8% according to the uncorrected data), 0.7 pp more than in Q1. This increase in employment, along with a smooth acceleration in the labour force translated into a very significant reduction in unemployment (–9.6% year-on-year), which took the rate of unemployment to 9.3%.

On QNA data, employment displayed a favourable trend in all sectors in Q1, except agriculture, where the process of job shedding, that commenced at the beginning of last year continued. The EPA data for Q2 indicate that the buoyancy of employment in this quarter was underpinned by job creation in construction and services, while in agriculture and industry year-on-year growth of employment was close to zero. In particular, according to the corrected series in each case, the year-on-year growth of agricultural employment turned positive in Q2 (0.5%), after falling during the previous six months, while employment in industry slowed sharply, to 0.3%, 0.7 pp below the growth rate in Q1. Construction recorded year-on-year employment growth of 7.5%, although that was actually a slight slowdown from Q1. Finally, with the net creation of almost 360,000 jobs in Q2, employment in services accelerated strongly to a year-on-year growth rate of 6.2%, up more than one point from the previous quarter.

According to the National Accounts, the growth of total employment in Q1 was primarily due to the increase in the numbers of self-employed (whose year-on-year growth rate increased by almost one percentage point, to 3.4%), while dependent employment expanded at a rate of 3% year-on-year, 0.1 percentage point more than in the previous quarter. For their part, the EPA data indicate a very notable acceleration in dependent employment in Q2, to growth of 6.2%, up 1.5 pp from the beginning of the year. In the case of self-employed workers, there was a sharp fall year-on-year in this quarter (of 1.9%), interrupting the above-2% growth path of the previous five quarters. According to the statistics for social security registrations, self-employment was more buoyant in Q2, reaching a year-on-year growth rate of 5.6% in June.

As regards the duration of contracts, according to EPA data, the number of temporary employees again grew at a very high rate in 2005 Q2, heightening the buoyancy of recent quarters. In particular, the number of workers with temporary contracts increased at a rate of 13.2% in that quarter, almost 5 pp up from the first quarter and well above the rate of permanent employment in the same period (3%). As a result, the ratio of temporary to total employ-

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3. The rates of the indicators mentioned in the text refer to gross data.

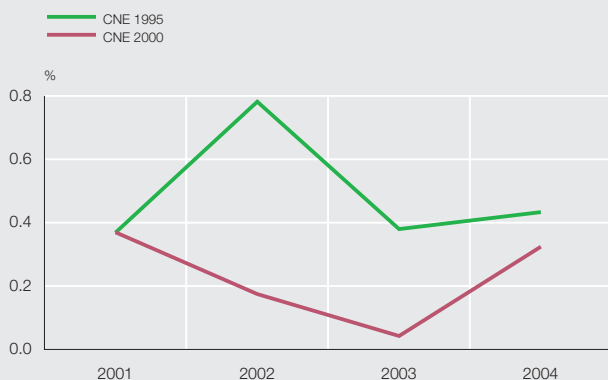
The low growth of apparent labour productivity, measured in terms of value added per employee, has been one of the basic features of the growth pattern of the Spanish economy in recent years. The path of this variable has been modified, to some extent, by the revision of the GDP and employment figures carried out by the INE following the publication of National Accounts figures with base year 2000 (CNE 2000), for the period 2000-2004. This box makes a preliminary analysis of the recent path of productivity, using a broad sectoral breakdown so as to identify the pattern in each sector.

The new CNE estimates have revised down the average labour productivity growth in the period 2001-2004 by 0.3 pp, so that the average growth of this variable was reduced to 0.2% for the total economy and to zero in the market economy. By branch of activity, the sharpest downward revisions were in agriculture (-1.8 pp) and in construction (-1.3 pp); they were connected to the higher employment growth assigned to these sectors. In the industrial branches, the downward revision was smaller (-0.4 pp), while in services, somewhat higher productivity growth was estimated (0.2 pp) than with CNE 1995, owing to the revision made to market services<sup>1</sup>.

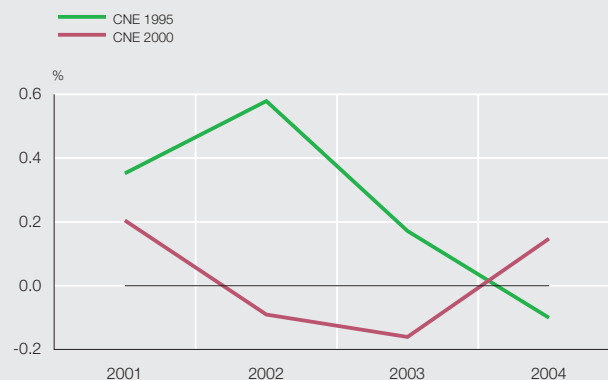
1. This upward revision to labour productivity may be partly explained by the increase in the value added figures in market services arising from the methodological change in the accounting for FISIM (financial intermediation services indirectly measured). At the same time, the upward revision to the job creation figures in this sector was small and considerably less than that made in the EPA figures.

## VALUE ADDED PER EMPLOYEE

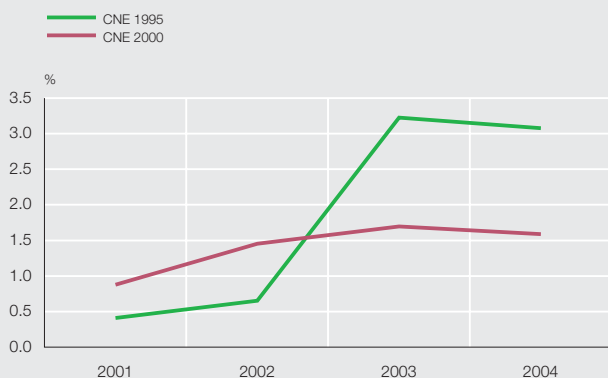
### TOTAL ECONOMY



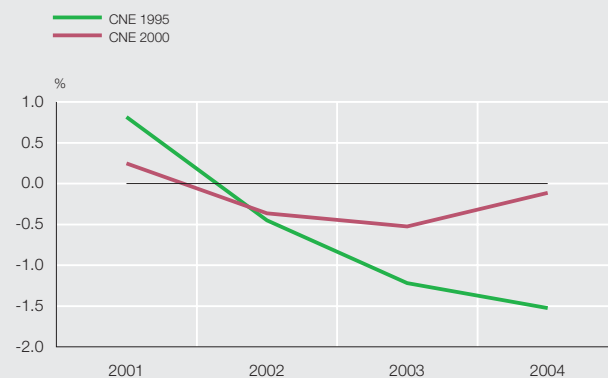
### MARKET ECONOMY



### INDUSTRY



### MARKET SERVICES



SOURCE: INE

In addition, the CNE 2000 has modified the profile of productivity growth estimated using the previous figures, with the result that productivity picked up slightly in 2004, following the slowdown in the previous two years, with growth of 0.3% in the total economy and 0.1% in the market economy (see adjoining chart). At the sectoral level, the profiles of labour productivity growth are smoother than previously. In agriculture and in construction this revision has resulted in very stable declines in productivity between 2001 and 2004 (around 0.6% in agriculture and 0.9% in construction). Meanwhile, in the industrial branches, there was a sharper downward revision to the previous estimates of more than 3% productivity growth in the last two years. Also, it should be noted that in market services the new estimates still show negative behaviour over the last two years, but without reaching the falls in productivity of more than one percentage point estimated using CNE 1995.

At a more disaggregated level, the CNE 2000 estimates indicate that, on average in the period 2001-2004, productivity growth in industry was broadly spread across the various sub-sectors, although chemicals, rubber and plastics and electrical equipment stand out for their dynamism, with average growth of more than 2%. On the negative side, textiles and wood and cork were notable, with falls in productivity in the period 2001-2004. Meanwhile, in the market services sector, productivity fell very sharply (by more than 1% per year) in three sub-sectors which account for 80% of the employment of the sector

(distribution, hotels and restaurants and business services), where job creation has been very intense in recent years. Transport and communications posted positive, albeit rather low, productivity growth (0.6%) and, finally, the performance of productivity in financial intermediation was notable, with average growth in this period of 5.1%.

The lower productivity growth according to the CNE 2000 has not resulted in an upward revision to firms' unit labour costs, since the increase in compensation per employee has been revised downwards by even more. Thus, the increase in business margins is even

larger than previously estimated. In short, according to the sectoral information, the revisions made to productivity growth have been more intense in some cases, although the behaviour across sectors remains varied. In particular, there were declines in agriculture, construction and market services, which contrast with the annual increases in productivity of more than one percentage point in the industrial and non-market services sectors. It will be possible to analyse the behaviour of productivity in the Spanish economy in more detail when series of value added per employee with base year 2000 become available for a longer period and when total factor productivity has been estimated using the new information.

ment rose by more than 2 pp with respect to the same quarter last year, to 33.3%. The information provided by INEM contract statistics also showed a high degree of buoyancy in this second quarter (with a rise of 10.1%), recovering the levels displayed a year ago.

As regards the duration of the working day, full time employees recovered a higher rate of growth in this quarter, to 2.7%, closer to the level of last year, following the slowdown recorded in the first quarter. By contrast, the number of part-time employees slowed in the quarter, although it maintained very high year-on-year growth rates (28.5%). As a result, the part-time ratio declined by 0.3 pp from the previous quarter (to 12.8%), although it stood 2 pp higher than its level a year previously.

The labour force was more buoyant in 2005 Q2, with a growth rate of 3.4%, 0.1 pp more than in the preceding quarter. Behind this behaviour lies a significant increase in the participation rate, which reached 57.4%, one percentage point more than in the same period a year earlier. In 2005 Q2, the number of unemployed persons fell by 9.6% with respect to 2004 Q2, the rate of decline of unemployment intensifying. As a result, the rate of unemployment stood at 9.3%, 0.9 pp less than three months earlier and 1.4 pp below the level a year earlier. This positive performance by unemployment was partly confirmed by the most recent information provided by registered unemployment statistics, which showed a less intense decline in the number of unemployed persons: from a fall of 2.2% in Q1 to -3.6% between April and June.

### 4.3 Costs and prices

Compensation per employee, estimated within the framework of the QNA with base year 2000, increased by 2.9% in the economy as a whole in Q1, which was smaller than the increase recorded in the preceding period (3.1%). There was a similar slowdown in the market economy, where compensation grew by 2.8% and, to a greater or lesser extent, in all non-agricultural branches (see Chart 20). It should be stressed that the QNA base year 2000 estimates have involved a downward revision in the level of compensation per employee, both in the main aggregates (of 2.4% in the economy as a whole and of 4.7% in the market economy) and in the non-agricultural market branches, while the opposite has occurred in agriculture and non-market services. By contrast to the QNA, the Quarterly Labour Cost Survey (ETCL) shows an acceleration in the monthly labour cost per worker in 2005 Q1 to 3% year-on-year, from 2.7% in 2004 Q4, which stemmed from the acceleration in the non-wage component, the growth rate of which rose (by 1.2 pp) to 4.2%, while wage growth slowed slightly to 2.5% from 2.6% in the preceding period.



SOURCES: INE, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

- a. Percentage change on same quarter a year earlier.
- b. Rates based on QNA seasonally adjusted series.
- c. Previous year's indexation clause.
- d. Settlement in the year to date.

The collective agreements registered in the first half of the current year reflect a wage settlement of 2.9%, similar to that agreed in 2004, before including indexation clauses. At the end of June, the number of workers with agreements for 2005 exceeded 5,500,000, most of whom (88.6%) were covered by revised agreements, with a settlement of 2.9%, while in newly signed agreements (affecting 633,000 workers) the settlement was half a point higher (3.4%). Overall, wage rates have been following the guidelines set by the Interconfederal Collective Bargaining Agreement (AINC) signed on 4 March by the social agents. However, given that there are still a large number of new agreements to be negotiated, it seems likely that by the end of the year the collective bargaining outcome will be somewhat higher settlements than those negotiated so far. The application of indexation clauses, which appeared in the agreements covering 77% of workers in December 2004, raised the settlements in 2004 to 3.6%, but their repercussions on labour costs will be felt in the current year, the impact being assessed as 0.6 pp, as compared with 0.2 pp in 2003. In the period to May, these clauses for 2005 were present in a similar percentage of agreements.

The moderation in the growth of compensation per employee in Q1 resulted in a smaller increase in labour costs per unit of value added, since the growth rate of value added per employee held steady. In particular, the labour cost per unit of value added decelerated by 0.2 pp to 2.5% in Q1. By contrast, the rate of growth of the value added deflator climbed to 4.1%, from 4% in the previous period. As a result of this divergent behaviour, the unit surplus increased by 6.7%, so that the widening of margins seen in previous quarters continued. In the market economy margins also widened, against a background of a cost slowdown similar to that in the economy as a whole, while the growth rate of prices held steady (see Chart 21).

In Q1 there were certain differences in the behaviour of the deflator and unit labour costs in the market economy and in the main branches that make it up. The deflator accelerated in industry and energy (also in agriculture), while in construction and in market services its growth was unchanged from 2004 Q4. By contrast, unit labour costs slowed in industry and energy and in





SOURCES: INE and Banco de España.

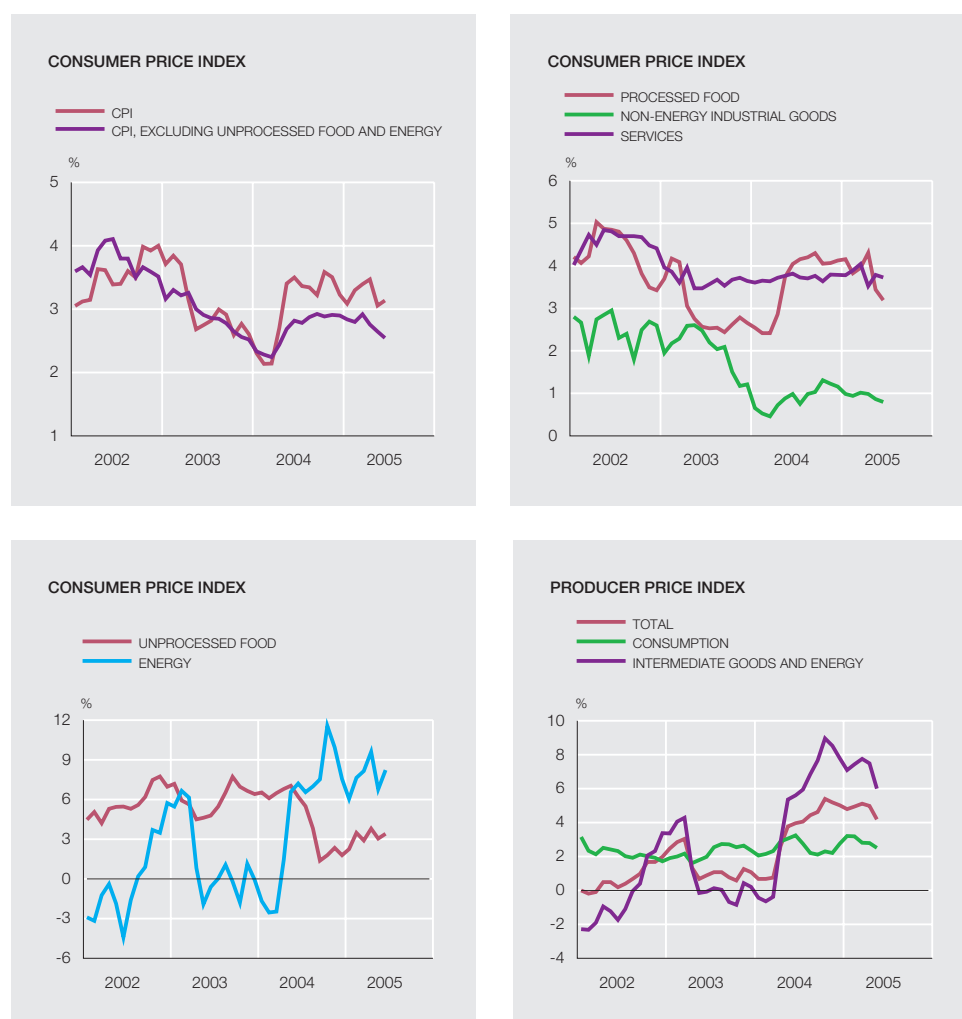
a. Percentage change on a year ago based on QNA seasonally adjusted series.

construction, remaining unchanged in market services. Despite these differences, the widening of margins was common to all branches of activity. The indicators available for Q2 show continuation of these patterns, although it is possible that price and cost increases, especially in industry and energy, are converging. When wage cost developments are analysed from the employer's viewpoint, i.e. deflating by the prices they face, as measured by the GVA deflator, the growth rate of compensation per employee (in real terms) in the market economy as a whole, can be seen to have turned negative again, favouring job creation.

The year-on-year growth rate of the final demand deflator increased by 0.1 pp to 4.2% in Q1, while that of the GDP deflator held steady at 4.2% and that of imports accelerated by 0.7 pp to 4.9%, as a consequence of the rise in oil prices and the depreciation of the euro

In Q1, the private consumption deflator slowed by 0.2 pp to a year-on-year growth rate of 3.4%, in contrast to the upward growth path last year. The CPI displayed a similar profile; it's year-on-year growth rate stood at 3.3% in Q1, 0.1 pp less than in the previous quarter. It fell again by 0.1 pp in Q2, while the CPI excluding unprocessed food and energy, after the stability displayed from last summer, declined by 0.3 pp to average growth of 2.6% in the period April-June (see Chart 22). As usual during the last twelve months, the most inflationary component was again energy prices, with average growth of 8.3%, the April increases in natural and calor gas having contributed to this outcome. In addition, fuel prices followed an upward



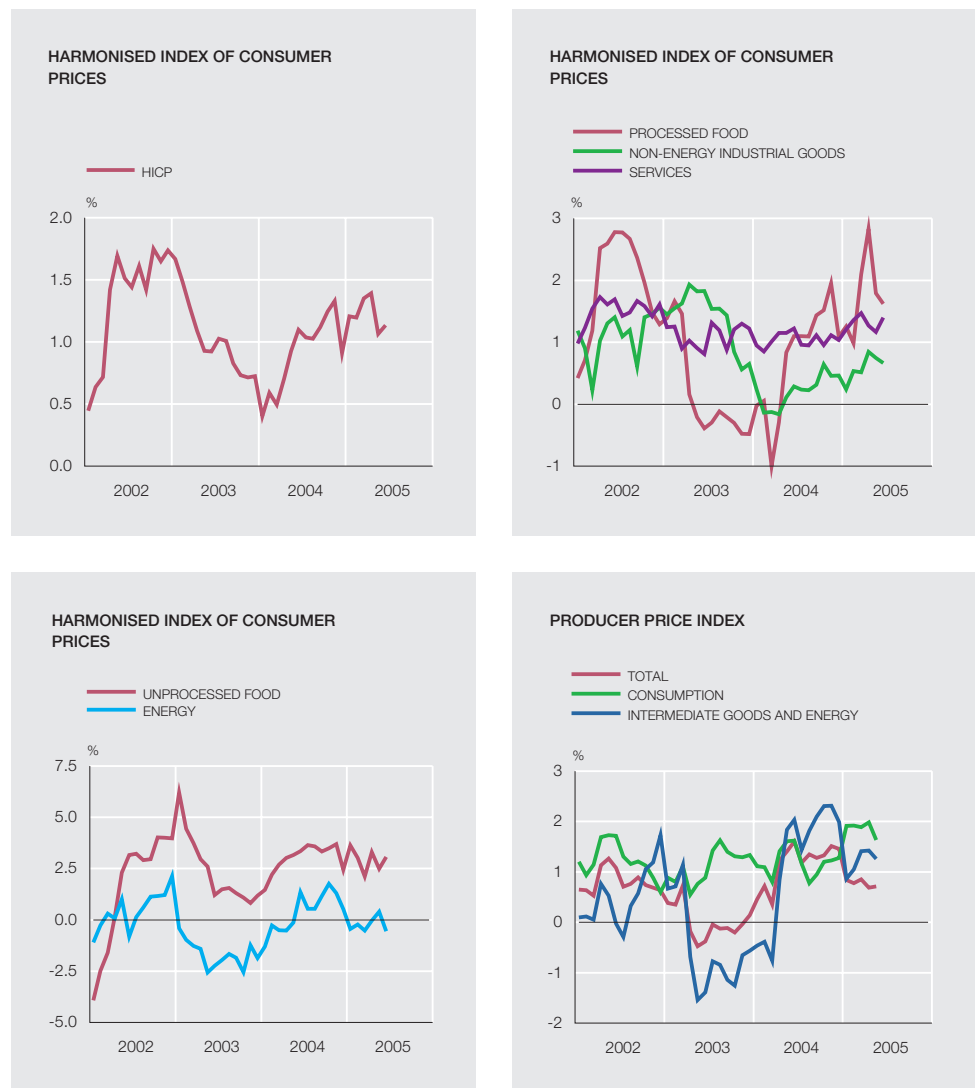


SOURCE: INE.

a. Twelve-month percentage change based on the original series.

course during the quarter, in step with the trend in oil prices on international markets. In Q2, the average price of oil rose by three dollars a barrel. Meanwhile, the average year-on-year growth rate of unprocessed food prices increased by 0.5 pp, to 3.4% in Q2. That of fruit and vegetable items accelerated, possibly because of the cold weather in February. Owing to the methodology for incorporating the prices of these goods into the CPI (using moving averages), this has led to subsequent increases.

The slowdown in the CPI excluding unprocessed food and energy has been a reflection of the slower rate of growth of its three main components. Processed food prices decelerated by 0.4 pp in Q2, relative to Q1, taking the year-on-year growth rate to 3.6%. Services prices decelerated by 0.2 pp in Q2, to an average year-on-year rate of 3.7%. This was partly attributable to Easter, which entailed an acceleration in travel-related prices in March that was offset in the following month. In addition, the prices of telephony services continued to fall year-on-year, and the rise in prices in some transport services was partially curbed. Finally, the prices of non-energy industrial goods slowed by 0.1 pp, to an average year-on-year increase of 0.9% in Q2. In general, the prices of clothing and footwear behaved somewhat more moderately than last year, like the domestic producer prices for this kind of good.



SOURCES: Eurostat and Banco de España.

a. Twelve-month percentage change based on the original series.

In Q2, Spanish inflation as measured by the HICP fell by 0.1 pp to 3.2%, while in the euro area as a whole inflation held unchanged at 2%, so that the differential narrowed by only 0.1 pp (see Chart 23). The reduction in inflation in services is somewhat greater in Spain than in the euro area, with the consequent decline in the differential. In any event, the increases in services prices are still very high, and hamper the convergence of Spanish with euro area inflation. As for goods, the differential widened in processed foods and in non-energy industrial goods, having slowed more sharply in the euro area than in Spain. Both energy and unprocessed food prices displayed a similar acceleration in Spain and the euro area.

The producer price index (PPI) increased by 0.3% in June, so that its year-on-year growth rose slightly to 4.4%, owing to the rise in energy producer prices. The year-on-year growth of producer prices of intermediate goods continued to moderate, so that it is now at half its level at the beginning of 2005, partly owing to the trend in the prices of metals. The year-on-year growth of the producer prices of capital equipment held very steady, at around 2%, while the year-on-year growth rate of the producer prices of consumer goods fell to 2.2%, owing to the ongoing moderation in the increases

EUR m and %								
	Outturn 2004	Percentage change 2004/2003	Initial Budget 2005	JAN-MAR outturn Percentage change 2005/2004		Outturn		
						2004 JAN-JUN	2005 JAN-JUN	Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
<b>1 REVENUE</b>	115,270	5.1	117,592	2.0	13.8	47,670	55,775	17.0
Direct taxes	58,668	3.8	63,689	8.6	23.0	19,337	23,592	22.0
<i>Personal income tax</i>	30,405	-7.4	33,703	10.8	16.6	13,608	16,572	21.8
<i>Corporate income tax</i>	26,019	18.7	27,901	7.2	--	4,587	6,012	31.0
<i>Other (a)</i>	2,244	26.5	2,085	-7.1	2.0	1,142	1,008	-11.7
Indirect taxes	41,350	5.8	43,051	4.1	18.7	21,385	25,418	18.9
VAT	29,108	7.3	30,015	3.1	22.0	15,214	19,320	27.0
<i>Excise duties</i>	9,751	-0.4	10,413	6.8	3.9	4,960	4,733	-4.6
<i>Other (b)</i>	2,491	14.9	2,623	5.3	14.5	1,211	1,366	12.9
Other net revenue	15,252	8.5	10,852	-28.9	-26.1	6,948	6,764	-2.7
<b>2 EXPENDITURE</b>	114,743	0.8	124,527	8.5	15.1	54,407	59,278	9.0
Wages and salaries	19,488	5.6	20,447	4.9	3.1	9,511	10,217	7.4
Goods and services	3,510	17.2	2,905	-17.2	-15.8	1,789	1,582	-11.6
Interest payments	16,760	-15.3	19,293	15.1	36.7	7,638	9,257	21.2
Current transfers	61,006	5.0	63,565	4.2	13.0	29,123	31,345	7.6
Contingency fund	...	...	...	...	...	...	...	...
Investment	7,104	-5.7	8,841	24.5	22.0	3,310	3,709	12.0
Capital transfers	6,875	-0.9	6,986	1.6	-3.1	3,036	3,169	4.4
<b>3 CASH-BASIS BALANCE (3 = 1 - 2)</b>	527	...	-6,935	...	--	-6,737	-3,503	...
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Resources	115,683	4.6	118,145	2.1	12.7	46,836	53,290	13.8
Uses	125,546	11.6	121,538	-3.2	5.2	52,184	54,484	4.4
<b>NET LENDING (+) OR BORROWING (-)</b>	-9,863	...	-3,392	...	...	-5,348	-1,194	...
(as a percentage of GDP)	-1.2		-0.4			-0.1	-0.6	

SOURCE: Ministerio de Economía y Hacienda.

a. Includes revenue from the tax on the income of non-residents.

b. Includes taxes on insurance premiums and tariffs.

in the prices of non-durable consumer goods. The growth differential with the producer prices of the euro area stayed, in May, at 0.7 pp, similar to its level at the beginning of the year. Among the other price indicators, those received by farmers accelerated sharply over Q1, primarily on account of the strongly upward movement in vegetable and fruit prices. Finally, the deceleration in hotel prices in previous months has intensified, so that the prices in May were similar to those of the previous year.

#### 4.4 The State budget

The figures published for the State budget outturn to June, based on National Accounts methodology, show a deficit of €1,194 million (0.1% of GDP), as against the deficit of €5,348 million (0.6% of GDP) in the same period last year. This improvement was due to the dynamism of taxes, which boosted the growth of resources to 13.8%, while uses increased by 4.4% during this period (see Table 3). There was also an improvement in the State deficit in cash-basis terms. In the first half this deficit was €3,503 million, as against €6,737 million in the same period of last year. This reduction in the deficit contrasts strongly with the increase budgeted for the year as a whole, and is basically due to a much larger than expected increase in revenues, since payments increased in line with projections. As for the Social Security budget outturn, see Box 4.

The Social Security System posted a surplus of €7,488 million to April 2005, up €616 million (9%) from the same period of the previous year, with 7% growth in revenues and 6.4% growth in expenditure (see adjoining table).

Receipts from Social Security contributions rose by 7.1% to April, similar to the rate in the second half of 2004. Social Security registrations increased by 3.4% to June 2005, an acceleration from the growth recorded in the previous three years. If the 250,175 foreign workers registered during the period to 30 June as a consequence of the legalisation process are deducted, the growth in the number of registrations in the first half of 2005 is 3.1%, slightly above the rate recorded in 2004.

With regard to expenditure, that on contributory pensions grew by 6.9% to April, slightly below the projection for the year as a whole. The number of contributory pensions is following a very moderate path, and its growth held steady at 0.8%, the same rate as projected and as recorded in the previous year. Meanwhile, spending on sickness benefits increased by 8.3% in the

first four months of the year, well below the budget projection.

With respect to the State Public Employment Service (SPEE), whose data is not included in the adjoining table, which refers exclusively to the Social Security system, the contributions received increased by 6.6% to February, in line with the budget projection, while rebates on contributions in respect of employment-promoting contracts increased by 18.4% in the first two months of 2005, as compared with a budgeted freeze.

SPEE spending on unemployment benefits rose by 6.3% to May, as compared with the increase of 9.6% in 2004 as a whole. This slowdown was prompted by the behaviour of the number of beneficiaries, which grew by 2.3% to April, as against 5.6% on average in 2004. This behaviour was, in turn, the result of two opposing factors. On the one hand, there was a fall in registered unemployment of 1.3% in the first half of 2005, as against growth of 1.6% in the whole of the previous year. On the other hand, the eligibility ratio increased, to 58.8% to April 2005.

#### SOCIAL SECURITY SYSTEM (a)

#### Transfers to regional governments allocated (b)

#### Current and capital transactions, in terms of recognised entitlements and obligations

EUR m and %

	Budget			Outturn JAN-APR		
	2004	2005	% change	2004	2005	% change
	1	2	3 = 2/1	4	5	6 = 5/4
1 REVENUE	82,217	90,040	9.5	28,895	30,917	7.0
1.1 Social security contributions (c)	76,753	83,915	9.3	26,932	28,840	7.1
1.2 Current transfers	4,672	4,874	4.3	1,688	1,646	-2.5
Other (d)	793	1,251	57.8	275	431	56.6
2 EXPENDITURE	78,691	84,100	6.9	22,023	23,429	6.4
2.1 Wages and salaries	1,907	1,998	4.8	579	647	11.8
2.2 Goods and services	1,497	1,566	4.6	370	417	12.9
2.3 Current transfers	74,775	80,060	7.1	21,026	22,329	6.2
Benefits	74,774	80,059	7.1	21,026	22,328	6.2
Contributory pensions	64,307	68,905	7.1	17,999	19,234	6.9
Sickness	5,312	5,925	11.5	1,556	1,686	8.3
Other	5,155	5,229	1.4	1,471	1,409	-4.2
Other current transfers	1	1	0.3	0	0	—
2.4 Other (e)	512	476	-7.0	48	35	-26.5
3 BALANCE	3,526	5,940	68.4	6,872	7,488	9.0

SOURCES: Ministerio de Economía y Hacienda, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

a. Only data relating to the system, not to the entire social security funds sector are given. This is because the figures for other social security funds are not available until April 2005.

b. Transfers from the ISM to the regional governments to finance transferred health-care and social services have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.

c. Including surcharges and fines.

d. Excluding surcharges and fines.

e. Reduced by the disposal of investments.

It should be pointed out that the strong growth in revenues, both in National Accounts and cash-basis terms, partly reflects a certain lag in the rate of making rebates (especially those for corporate income tax and VAT), so that a slowdown in revenues is projected for the second half, although the projected growth rate is still above the initial forecast. In consequence, the State budget outturn in this first part of the year points to a better-than-expected outturn for the year as a whole. At the same time, the discrepancy between the two balances is basically due to the adjustment arising from the different accounting treatment of interest payments.

As for cash-basis revenues, these rose by 17% to June, owing to the strength of the main taxes, in sharp contrast to the budget forecast of a 2% increase for 2005 as a whole. However, the acceleration in revenues in Q2, in comparison with Q1, was attributable to the moderation in the rate of fall of non-tax revenues. IRPF (personal income tax) receipts increased by 21.8% (in particular, withholdings on earned income rose 16.4%, while the legalisation of immigrants is not expected to have a significant impact on these receipts). For their part, corporate income tax receipts, following the first payment on account in April, grew by 31% in the first half, although partly owing to delayed rebates. The buoyancy of VAT receipts intensified in Q2 (with growth of 27%). However, a significant lag has built up in the timing of rebates with respect to the previous year, which will probably be corrected in the second half, causing these revenues to slow. Even so, although it is very likely that receipts will still remain above the initial projection. Excise duties fell by 4.6%, following the moderate increase in Q1, owing especially to the trend in the hydrocarbon tax (with a fall of 12.7% to June, owing to the moderation in the consumption of these goods, given their high prices). As for the chapters aggregated under the heading "other net revenue", the decline recorded was determined by sharp reductions in the revenues from the Banco de España and in the funds received from the European Union (transfers that behave very erratically), although during Q2 these falls were partly offset by the recovery in the "charges" chapter.

Cash-basis expenditure, meanwhile, slowed in Q2, to a year-on-year growth rate of 9% in the first six months, in line with the budget projection. The slowdown was marked by interest payments, current transfers (with a weight of somewhat more than 50% of total expenditure) and investment. It should be noted, however, that the overall trend in expenditure should not be influenced by the restructuring of the railway system, given that the higher state interest payments and investment expenditure is offset, respectively, by lower volumes of current and capital transfers to RENFE, from 2005. Operating expenses (wages and salaries and goods and services), for their part, accelerated in Q2, although the goods and services item maintained negative rates, owing to the lower expenditure on elections, in comparison with a year earlier.

#### **4.5 The balance of payments and the capital account of the economy**

In the first four months of 2005, the overall balance on current and capital account was a deficit of €19,269 million, twice the level a year earlier (see Table 4). This result was basically a consequence of the notable deterioration in the current account balance, with the deficit doubling to €20,782 million and, to a lesser extent, of the slight fall in the capital transactions surplus, relative to the same period of 2004. The main current account items deteriorated, especially the trade deficit and the negative income balance, although the positive travel and current transfers balances also declined. By contrast, the non-travel services deficit improved slightly.

In the period January-April 2005, the trade deficit was €20,520 million, up €6,545 million from the same period a year earlier. In year-on-year terms, the negative balance increased by 47%, so that last year's deterioration intensified. This significant increase in the trade deficit stemmed from the weakness in this period of real export flows, and from the vigour of imports, against

EUR m		JANUARY-APRIL	
		2004	2005
<b>CREDITS</b>	CURRENT ACCOUNT	82,216	84,055
	Goods	48,220	49,884
	Services	19,079	19,177
	<i>Travel</i>	9,110	8,889
	<i>Other services</i>	9,969	10,288
	Income	8,151	8,152
	Current transfers	6,767	6,842
	CAPITAL ACCOUNT	1,960	1,673
	CURRENT + CAPITAL ACCOUNTS	84,177	85,728
<b>DEBITS</b>	CURRENT ACCOUNT	92,621	104,836
	Goods	62,194	70,404
	Services	14,559	15,261
	<i>Travel</i>	2,662	3,370
	<i>Other services</i>	11,897	11,891
	Income	10,770	13,032
	Current transfers	5,097	6,140
	CAPITAL ACCOUNT	228	160
	CURRENT + CAPITAL ACCOUNTS	92,849	104,997
<b>BALANCES</b>	CURRENT ACCOUNT	-10,405	-20,782
	Goods	-13,974	-20,520
	Services	4,520	3,916
	<i>Travel</i>	6,448	5,519
	<i>Other services</i>	-1,928	-1,603
	Income	-2,619	-4,880
	Current transfers	1,669	702
	CAPITAL ACCOUNT	1,732	1,513
	CURRENT + CAPITAL ACCOUNTS	-8,672	-19,269

SOURCE: Banco de España.

a. Provisional data.

a background of a widening in the growth differential vis-à-vis Spain's main trading partners, and also from the sharp increase in the energy bill, in step with the rise in oil prices on international markets.

As for the services balance, in the first four months of 2005 there was a surplus of €3,916 million, below the level of the same period of 2004. This deterioration is explained by the decline in the travel surplus (-14%), since the non-travel services deficit was corrected somewhat. Travel revenues fell by 2.4% in the first four months of the year (cutting short the recovery they displayed at the end of the previous year), in line with the slowdown in this period of the indicators of foreigner's overnight stays in hotels and tourist flats. For their part, driven by the strength of the euro, travel payments rose by 26.6% in the period January-April, sustaining the notable vigour that characterised them last year.

The negative income balance deteriorated significantly in the first four months of 2005, to stand at €4,880 million. Credits were notably slack (-0.3%), while debits rose by 20.7%, owing to the increase in payments made by financial institutions and by the resident non-financial private sector.

The current transfers surplus stood at €702 million, in the period January-April, less than half the level in the same period of 2004. Credits barely increased by 1.5%, despite the favourable behaviour of flows from the EU under EAGGF-Guarantee. However, those to the public sector under the European Social Fund fell. Debits, for their part, increased at a very high rate of 20.5%, basically as a consequence of the notable increase in payments made to the EU under GNP resource and VAT resource. Likewise, workers' remittances grew at a high rate, although somewhat more slowly than in 2004.

Finally, the capital account surplus stood at €1,513 million in the first four months of 2005, down somewhat from the same period of 2004. This deterioration is explained by the notable decline in transfers from the EU's Cohesion Fund and EAGGF-Guidance, while the structural funds received under the ERDF increased.

## 5 Financial developments<sup>4</sup>

### 5.1 Overview

In 2005 Q2 the financial conditions of households and Spanish corporations were shaped by an environment of falling interest rates in the money and public debt markets. Thus between March and June average one-year Euribor decreased by 23 basis points (bp) to 2.1%, making for a flat yield curve between the one-month and one-year maturities. Even sharper was the decrease in the ten-year Spanish bond yield, down 54 bp to 3.19%, a record low. These developments, along with the continuing moderate levels shown by the risk premia of Spanish firms, led to a further contraction in the cost of financing with fixed-income securities. According to the most recent information available, the bank lending rates to firms and households did not change significantly in April and May, remaining at low levels (see Chart 24).

In late April Spanish and international stock market prices resumed the upward path that had been arrested for the previous two months, against a background of low volatility, low long-term interest rates and generally favourable profit figures published by listed firms for 2005 Q1. The terrorist attacks of 7 July in London triggered sharp falls in European stock exchange indices, although they later quickly recovered. Hence on 11 July the Madrid Stock Market General Index had gained nearly 9% since the beginning of the year. This performance was very similar to that of the broad EURO STOXX index of the euro area stock exchanges and much better than that of the US S&P 500, which was up by 3% in this period. In Spain, moreover, these developments were accompanied by high trading volumes.

As regards the market value of property, the latest official housing ministry data showed a certain decrease in its year-on-year growth from 15.7% in Q1 to 13.9% in the following quarter. However, given the short history of the new series prepared by the Ministry (in principle, more volatile than the old one), it is still too early to judge whether this represents the beginning of a clear change in trend.

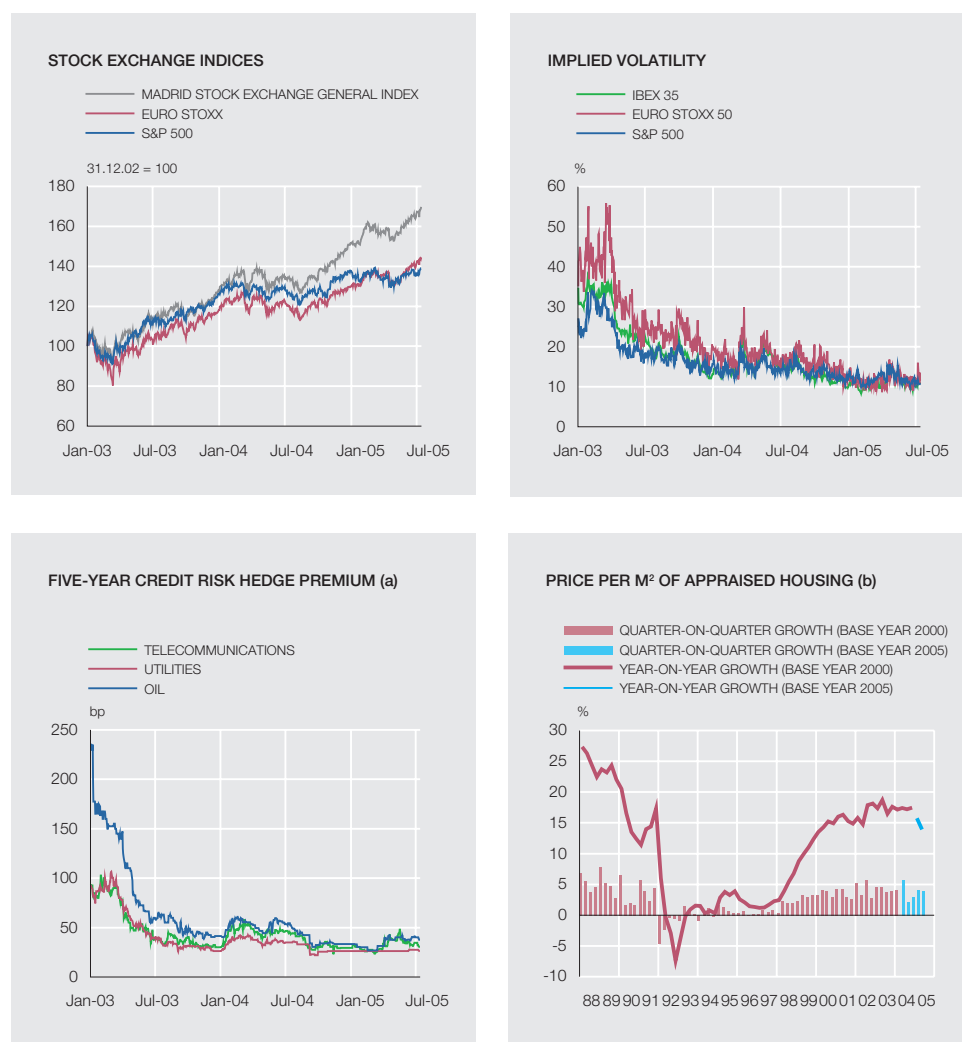
In this setting, the volume of financing received by the private sector in Q1 continued to show notable buoyancy. In particular, corporate borrowing accelerated and its year-on-year growth stood at nearly 16%. For their part, the liabilities of households maintained a brisk pace of growth of around 20%. The breakdown of credit from resident institutions by loan purpose indicates that the most noteworthy feature between January and March continued to be the leading role of the property and construction sector. Another feature was the firming of the expansionary path apparent during 2004 in the funds channelled to industry, which were up by nearly 10% in year-on-year terms. The provisional information available up to May indicates that the debt of firms and households continued to follow the same pattern of previous months.

The aforementioned developments were reflected in a further worsening of the indicators of financial pressure on households. Thus, according to the Financial Accounts for Q1, the debit balance of this sector's financial transactions reached the equivalent of 0.4% of GDP (see Table 5). In addition, the debt and financial burden of households in relation to gross disposable

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4. The latest update of the Financial Accounts of the Spanish Economy (FASE) incorporates the revisions of the Spanish National Accounts (CNE) and of the Balance of Payments (see Methodological Note in the electronic update of the FASE). Also, the new CNE with base year 2000 entailed changes in the levels of financial indicators expressed as ratios of CNE variables, which in this Bulletin appear as a break in the year 2000, since these series are not available before that year. In the case of sectoral variables, use is made of provisional internal estimates consistent with the new CNE with base year 2000, since the sectoral accounts of the CNE have not yet been published. For this reason, the new levels of the indicators based on these variables should be interpreted with due caution.





SOURCES: Bloomberg, Credit Trade, Ministerio de Vivienda and Banco de España.

- a. Average asset-weighted premia. On 22.6.03 a change in the contractual conditions of European firms came into force. The new contract carries lower premia (around 10%)
- b. New statistic from 2004.

income (GDI) continued to increase, while their saving after debt service again decreased. However, their net wealth seems to have remained on its upward path, particularly insofar as its property component is concerned. The most recent provisional information indicates that both these trends have continued.

In the case of non-financial corporations, there were also increases in the aggregate debt/profit ratio and, of a moderate nature, in the interest burden. In addition, the debit balance of financial transactions increased notably to 5.3% of GDP, whereas the financing gap ceased to follow the slightly narrowing trend of previous quarters. However, the latest quarterly survey of the Central Balance Sheet Office (CBQ) indicates that the debt and financial burden ratios are holding steady against a backdrop of favourable profitability performance, which led to a further decrease in the synthetic indicator of financial pressure on investment and to the steady low levels reached by the employment indicator in recent months. Moreover, these developments were accompanied by an improvement in analysts' forecasts of listed companies' profits and greater buoyancy of lending to industry and, according to the Bank Lending Survey (EPB), of credit for investment in fixed capital.

% GDP (a)									
	2000	2001	2002	2003	2004				2005
					Q1	Q2	Q3	Q4	Q1
National economy	-3.2	-3.4	-2.5	-3.1	-3.1	-3.3	-3.6	-4.1	-4.9
Non-financial corporations and households and NPISHs	-3.1	-4.4	-3.7	-4.8	-4.3	-4.8	-5.4	-4.5	-5.7
<i>Non-financial corporations</i>	-4.7	-5.8	-4.7	-5.0	-5.0	-5.2	-5.3	-4.5	-5.3
<i>Households and NPISHs</i>	1.6	1.4	1.0	0.2	0.7	0.4	-0.1	-0.1	-0.4
Financial institutions	0.8	1.5	1.4	1.4	1.5	1.4	1.2	0.7	0.6
General government	-0.9	-0.5	-0.3	0.3	-0.2	0.1	0.6	-0.3	0.1
MEMORANDUM ITEM:									
Financing gap (b)	-14.8	-9.1	-9.4	-9.6	-8.3	-9.2	-8.6	-7.1	-8.7

SOURCE: Banco de España.

a. Spanish National Accounts, base year 2000.

b. Financial resources that cover the gap between expanded gross capital formation (real and permanent financial investment) and gross saving.

The continuing upward trend in the price of financial and real assets, and the low interest rates, continued to be conducive to the expansion of private consumption and residential investment in the last few quarters. However, as mentioned in previous reports, the level reached by indicators of financial pressure on households and the evidence of house overpricing constituted factors of risk for household expenditure at the medium and long term.

In the case of firms, although their aggregate debt and financial burden again increased, certain recent data at the microeconomic level pointed to an improvement. Thus in recent quarters the earnings prospects of listed companies have been revised upwards, the synthetic indicators of financial pressure constructed from CBQ data have remained at low levels and an increase has been observed in the demand for financing to industrial firms and for that relating to investment in fixed capital. Overall, this evidence, together with the sounder position of large corporations and the generous financing conditions, makes for a favourable scenario for the continued buoyancy of productive investment.

## 5.2 Households

The financing conditions for households remained highly favourable in 2005 Q2. In May the interest rates applied by credit institutions in new lending stood around the low levels seen in the preceding months. Specifically, the rates for house purchase and for consumer and other loans were 3.4% and 6.3%, respectively, similar to those at end-2004. The EPB for January-March 2005 indicates that the terms offered to households on house purchase loans continued to tighten moderately while those for other loans to the sector eased further, with institutions intending to maintain these policies between April and June.

Between January and March, household debt maintained the brisk rate of increase of the preceding quarters, with growth of nearly 20% in year-on-year terms, as has been the case since mid-2004 (see Table 6). The expansion of liabilities continued to be conditioned by the behaviour of the house-purchase component of credit, which grew by around 24%, representing a flow equal to 9% of GDP in cumulative twelve-month terms, up 0.6 pp on the 2004 figure. This expansionary behaviour of funds relating to the financing of property affects house prices in the manner discussed in Box 5. Meanwhile, consumer and other loans slowed somewhat

% GDP (a)				2004		2005
	2001	2002	2003	Q3	Q4	Q1
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	7.5	8.2	9.2	10.4	10.0	10.1
Cash and cash equivalents	1.1	3.6	4.2	4.0	3.9	4.3
Other deposits and fixed-income securities (b)	3.4	1.6	-0.1	1.4	1.9	1.7
Shares and other equity (c)	-0.2	0.6	0.6	0.6	0.1	0.0
Mutual funds	0.8	0.2	2.3	1.7	1.5	1.3
FIAMM	1.2	0.7	0.6	-0.3	-0.2	-0.1
FIM	-0.5	-0.5	1.7	1.9	1.6	1.2
Insurance technical reserves	2.6	2.5	1.8	1.8	1.8	2.0
Of which:						
Life assurance	1.4	1.4	0.7	0.7	0.7	0.8
Retirement	0.9	0.9	0.9	0.8	0.9	0.9
Other	-0.1	-0.3	0.5	0.8	0.8	0.9
Financial transactions (liabilities)	6.1	7.2	9.0	10.5	10.0	10.5
Credit from resident financial institutions (d)	5.2	6.9	8.9	10.4	10.5	10.7
House purchase credit (d)	4.6	4.9	6.9	8.3	8.6	9.0
Consumer and other credit (d)	0.6	2.0	2.0	2.1	1.8	1.6
Other	0.9	0.3	0.1	0.1	-0.4	-0.2
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	14.6	14.6	16.2	15.3	15.0	16.9
Cash and cash equivalents	1.6	1.6	0.8	1.1	1.0	1.2
Other deposits and fixed-income securities (b)	0.9	1.7	1.4	0.2	0.9	0.9
Shares and other equity	5.4	6.6	7.4	5.5	4.2	4.8
Of which:						
Vis-à-vis the rest of the world	3.9	4.8	4.5	3.3	2.6	3.4
Other	6.8	4.7	6.5	8.4	8.9	10.0
Financial transactions (liabilities)	20.5	19.3	21.2	20.6	19.5	22.2
Credit from resident financial institutions (d)	6.0	5.9	6.8	7.9	9.3	10.1
Foreign loans	3.8	2.7	2.7	1.7	0.5	0.9
Fixed-income securities (b)	0.0	-0.4	-0.2	0.0	0.0	0.0
Shares and other equity	4.9	5.9	5.2	3.9	2.7	2.7
Other	5.8	5.1	6.7	7.0	7.0	8.5
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	15.4	14.1	16.0	16.7	16.3	17.4
Households and NPISHs	12.3	15.6	18.7	20.5	19.7	19.8
Non-financial corporations	17.7	13.1	14.0	13.9	13.8	15.5

SOURCE: Banco de España.

a. CNE, base year 2000.

b. Not including unpaid accrued interest, which is included under "other".

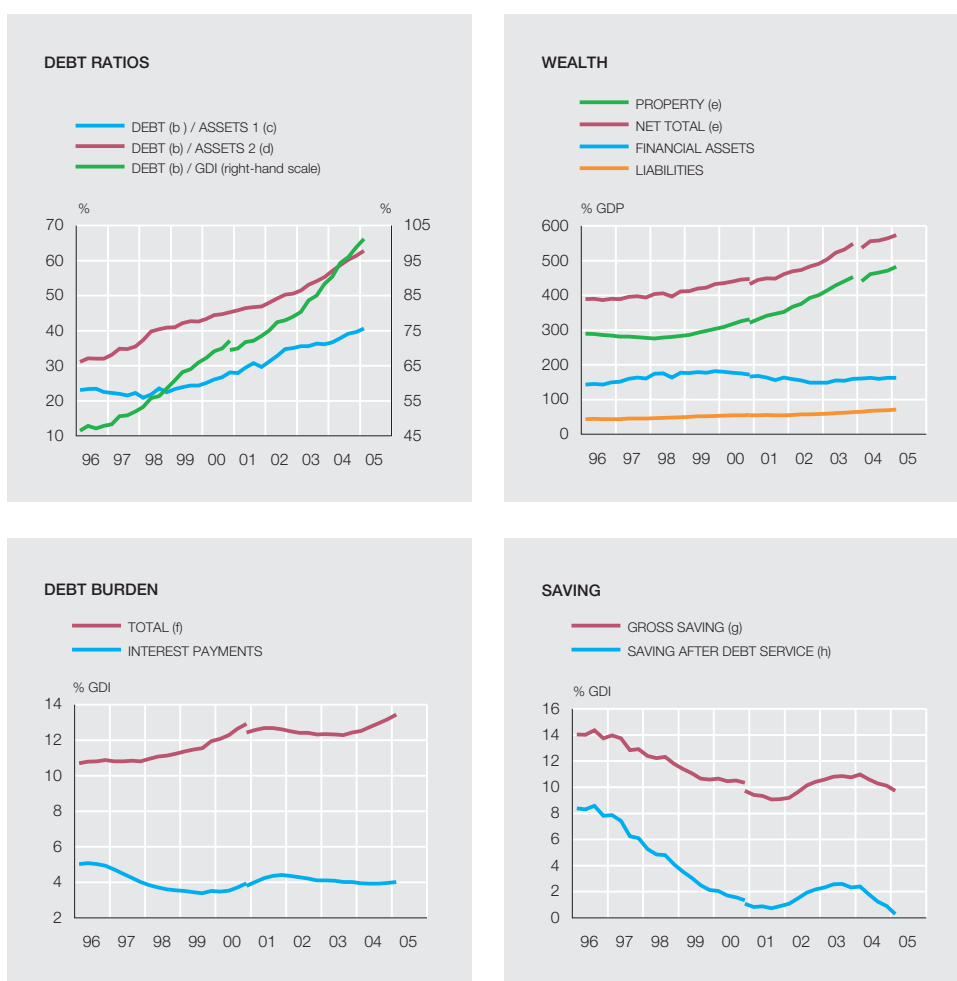
c. Excluding mutual funds.

d. Including securitised loans.

e. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation vehicles.

to a more moderate rate of increase of 10%. The provisional information available for the period up to May points to the continued buoyancy of house purchase debts and a slight pick-up in funds for other purposes.

Portfolio decisions by households in Q1 showed the same pattern as in 2004 (see Table 6). Thus the volume of funds invested in financial assets was very similar to that in 2004, amounting to nearly 10% of GDP in cumulative twelve-month terms. The main instrument chosen was



SOURCE: Banco de España.

- a. For the sectoral National Accounts data, from 2000 a provisional estimate consistent with CNE base year 2000 is used.
- b. Includes bank credit and securitisation.
- c. Assets 1 = Total financial assets - "other".
- d. Assets 2 = Assets 1 - shares - shares in FIM.
- e. Calculated on the basis of the estimated changes in the stock of housing, in the average area per house and in the price per square metre.
- f. Estimated interest payments plus debt repayments.
- g. Balance of households' use of disposable income account.
- h. Gross saving less estimated debt repayments.

again liquid, lower-risk assets (cash and deposits), the holdings of which increased by an amount equal to 6% of GDP. By contrast, the amount of share purchases was zero and net subscriptions for mutual funds continued to decrease, falling to 1.3% of GDP. Finally, investment in insurance technical reserves rose slightly to 2% of GDP.

The expansion of credit meant that household debt, measured in terms of GDI, continued to grow, and in March it passed the 100% level (see Chart 25)<sup>5</sup>. This development, along with the stability of the cost of borrowing, resulted in the associated financial burden increasing further to levels approaching 14% of GDI, which in turn led to a decrease in the sector's saving after debt service. In line with these developments, Q1 saw the debit balance of the sector's net financial transactions rise to 0.4% of GDP in cumulative twelve-month terms. Nevertheless, the Spanish

5. In the Spanish National Accounts with base year 1995 these levels had already been reached at end-2004.

Loans and house prices are closely related. Thus a rise in property values increases the amount of the guarantees that households have for requesting loans, which stimulates demand for them. On the other hand, a higher volume of financing facilitates the acquisition of these assets which, when supply is fixed in the short run, will tend to lead to rises in the prices of that asset. There is some descriptive evidence at international level of episodes of 2-way feedback between upturns in these two variables. This resulted in a build-up of imbalances that were subsequently corrected more or less sharply, in some cases with a severe impact on the banking system and on the economy in general. It is thus relevant to analyse empirically the interaction between these aggregates in Spain, particularly at the present when they are both growing at high rates.

To analyse the interaction between house purchase financing and house prices in the Spanish economy, a model was estimated which describes the long-run relationship between these two variables and their short-run dynamics (including the adjustment of imbalances with respect to the long-run paths)<sup>1</sup>. The results obtained, which are set forth in the accompanying table, show a positive correlation between the two variables in the short run. Thus when there is growth of 1

percentage point in loans (house value), the rate of increase of property prices (debt for purchasing this asset) rose in the period by 0.15 (0.09) pp, indicating that the movements in these aggregates reinforce each other.

The results also show that when the loans are not at their long-run equilibrium level, the two variables analysed tend to move to re-establish it. Specifically, when the debt stands one percentage point above (below) the level consistent with its long-run determinants, there occurs in the immediately following quarter a decrease (increase) in loans of 0.13 pp, and property prices decline (rise) by 0.08 pp. This dynamic is maintained in succeeding terms, with an implicit correction of 6.2% of the gap each quarter, so these effects are prolonged over a long period. By contrast, deviations from the equilibrium path in the housing market are corrected only through downward or upward changes in property prices of 0.07 pp per percentage point of imbalance depending on whether the overvaluation is positive or negative.

1. See Gimeno and Martínez-Carrascal (2005): *The interaction between loans for house purchase and housing prices. An analysis for Spain*, mimeo, Banco de España.

#### RESULTS OF ESTIMATION OF A MODEL FOR HOUSE PURCHASE LOANS AND PROPERTY PRICES (Quarterly figures for 1984-2004) (a)

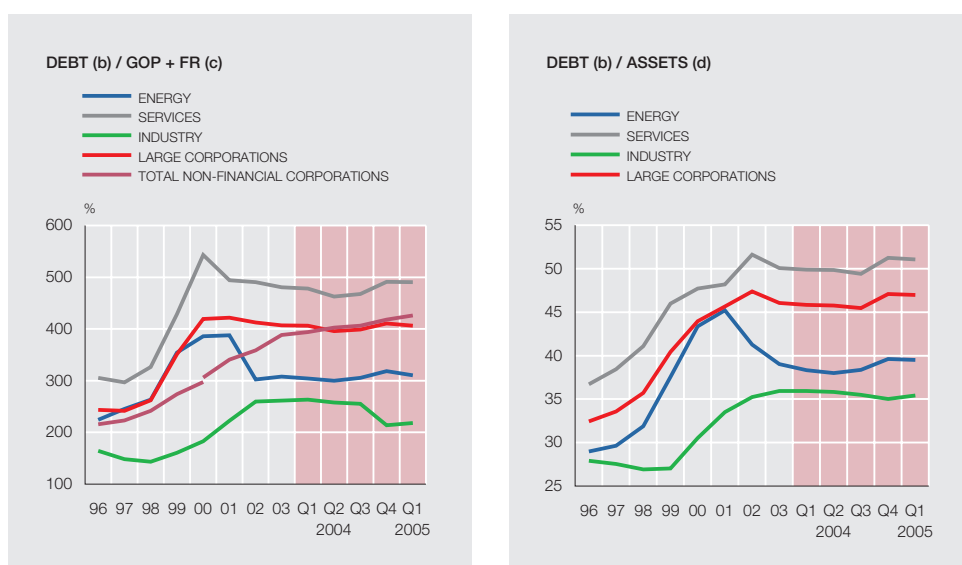
EXPLANATORY VARIABLE	Dependent variable	
	Loans (per household)	House price
Loan growth	—	0.150
House price growth	0.09	—
Labour income growth	0.23	—
Imbalance in loans (in previous quarter)	-0.13	-0.08
Imbalance in house prices (in previous quarter)	—	-0.07

a. The table shows the percentage changes (in one quarter) in each of the dependent variables (loans for house purchase and property prices) associated with a contemporaneous increase of one percentage point in the debt, property prices and labour income, and an imbalance of the same amount in each of the dependent variables in the previous quarter. All variables are expressed in real terms and labour income is corrected for outliers.

family expenditure survey shows that the percentage of households able to save held on a path of mild growth, standing at 38.5% in 2005 Q1, while the proportion of households reporting some degree of difficulty in getting to the end of the month decreased slightly to 54.7%.

Finally, in 2005 Q1 the sector's wealth again increased, mainly as a result of the upward trend in the price of property assets. As a result of this rise, the theoretical effort required to buy a new house increased once again: first, the financial burden in the first year of a theoretical loan that, at the current rates and terms, would finance 80% of the value of the property now represents 35% of GDI per household; and second, the house price/GDI per household ratio increased again<sup>6</sup>.

6. The changes in this ratio proxy the changes in the effort required to make the down payment for house purchase and in the time that a certain theoretical level of effort would have to be maintained to purchase a property and repay in full the standard associated loan.



SOURCE: Banco de España.

a. Indicators calculated drawing on the CBSO annual and quarterly surveys (CBA and CBQ), except the series «Total non-financial corporations», which was obtained from the National Accounts (CNE and FASE). From 2000, a provisional estimate consistent with the CNE with base year 2000 was used.

b. Interest-bearing borrowed funds.

c. Gross operating profit plus financial revenue.

d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.

### 5.3 Non-financial corporations

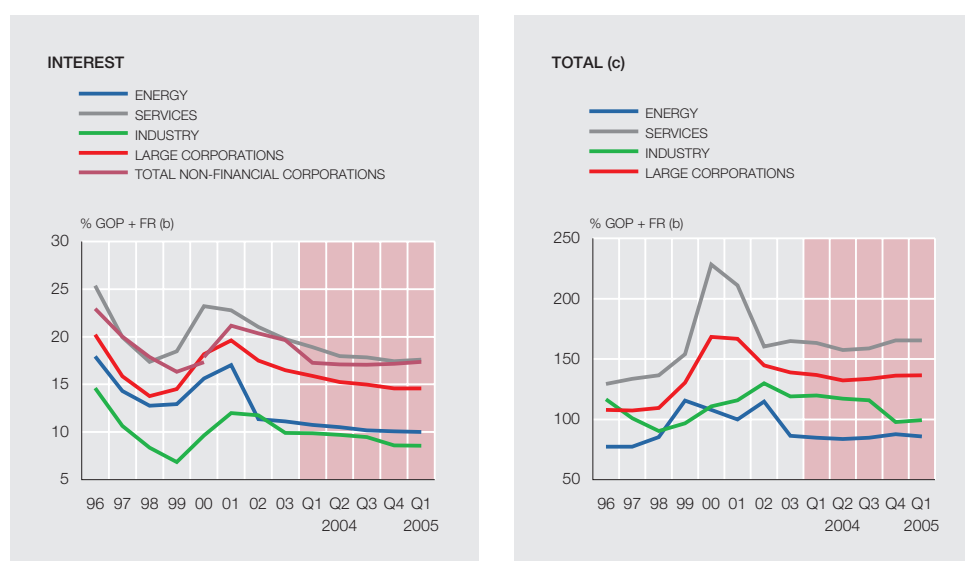
The financing conditions of corporations underwent slight changes, remaining extremely favourable in the first quarter of the year. Thus in May the interest rates applied by credit institutions in new lending business held at low levels, standing at around 4% and 3% depending on the volume of the transaction. Furthermore, according to the EPB for Q1, the loan approval criteria were less strict, against a backdrop in which, in line with what had been expected, the demand perceived by institutions continued to accelerate significantly. Also, the surveyed institutions expected this pattern to hold between April and June. Meanwhile, the cost of financing on the fixed-income markets decreased owing to the downward course of public debt yields and to the continuing low level of risk premiums. Similarly, the upward path of stock exchange indices from May, along with their low volatility, improved the conditions for raising funds on the equity markets.

In this setting, the volume of liabilities-side transactions of corporations in Q1 was considerable, amounting to more than 22% of GDP in cumulative twelve-month terms, up 2.7 pp on the 2004 figure (see Table 6). As regards instruments, the main source of funds was loans, the flow of which amounted to 11% of GDP, since no fixed-income securities were issued and the funds in the form of shares and other equity were equal to 2.7% of GDP. Although lending from non-residents increased, the financing from resident institutions was again the most expansionary component. In terms of rates of change, the year-on-year growth of the debt in March stood at more than 15%, which represented an increase of more than 1 percentage point with respect to end-2004. According to the available data, this upward course was maintained through to May.

The breakdown of bank credit by productive activity continued to show a high buoyancy of funds for construction and real estate services, which in March grew by more than 22% and 42%, respectively, compared with the same period in 2004. Lending to industry again accelerated notably for the fourth quarter running, with a year-on-year rate of increase of nearly 10%.

## DEBT BURDEN OF NON-FINANCIAL CORPORATIONS (a)

CHART 27

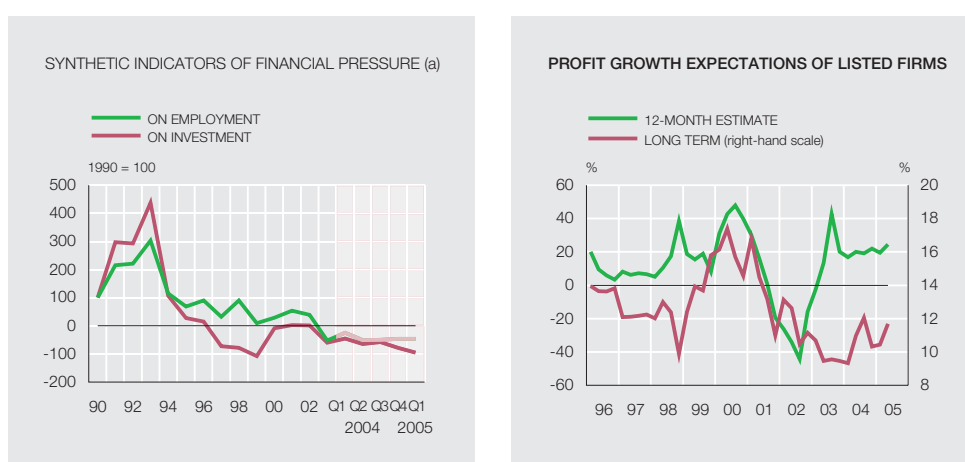


SOURCE: Banco de España.

- a. Indicators calculated drawing on the CBSO annual and quarterly surveys (CBA and CBQ), except the series «Total non-financial corporations», which was obtained from the National Accounts (CNE and FASE). From 2000, a provisional estimate consistent with the CNE with base year 2000 was used.
- b. Gross operating profit plus financial revenue.
- c. Includes interest plus interest-bearing short-term debt.

## OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 28

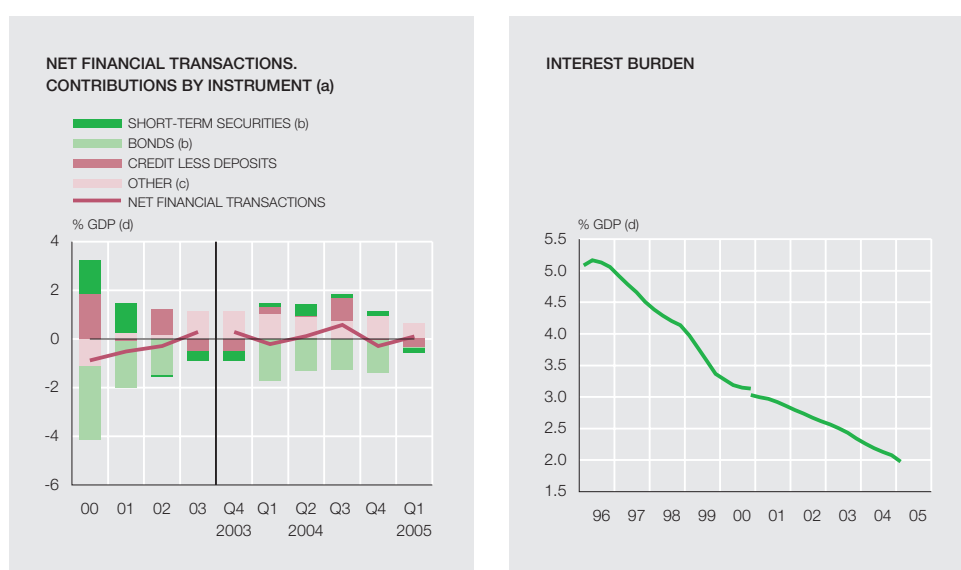


SOURCES: I/B/E/S and Banco de España.

- a. Indicators estimated drawing on the CBSO annual and quarterly surveys. A value above (below) 100 indicates more (less) financial pressure than the reference level.

In contrast, services (excluding real estate services) held on the mildly decelerating path seen throughout 2004. Finally, on CBQ information, large corporations continued to step up their borrowing, although at moderate rates.

On the assets side, the amount of non-financial corporations' transactions grew more moderately, moving up to 17% of GDP in cumulative twelve-month terms, nearly 2 pp more than in 2004. As regards instruments, there was an increase in the heading under which trade credit (included in the item "Other" in Table 6) is classified. Also notable was the recovery in investment in foreign shares by Spanish corporations.



SOURCE: Banco de España.

- a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.  
b. Includes only liabilities transactions.  
c. Includes unpaid accrued interest on bonds.  
d. CNE, base year 2000, from 2000 Q4.

As a result of the aforementioned changes in assets-side and liabilities-side transactions, net borrowing by corporations increased notably in 2005 Q1 and stood, in cumulative twelve-month terms, at 5.3% of GDP, up 0.8 pp on the 2004 figure (see Table 5). This development, along with the incipient recovery in foreign direct investment, meant that the financing gap, i.e. the net external funds needed to undertake gross capital formation and direct investment abroad, reversed its recent downward trend and rose to 8.7% of GDP. However, this indicator is still below the levels seen at the beginning of the current decade.

Owing to the buoyancy of borrowed funds, the sector's indebtedness continued to rise and in March it stood at 426% of gross operating profit plus financial revenue (see Chart 26). This movement, against a background of steadiness in the cost of financing, resulted in a slight increase in interest payments, which however remained at moderate levels around 17% of profits (see Chart 27). On CBQ information, both the debt ratio and the financial burden of the reporting corporations as a whole remained relatively steady, and no significant differences between the productive branches were apparent. Moreover, the ordinary net profit of these corporations grew briskly at around 14%, reflecting an additional improvement in corporate profitability. However, this positive development is explained partly by the favourable performance of financial revenue (basically dividends), since gross operating profit grew more slowly (5.9%). As a result of all these developments, the synthetic indicator of financial pressure on investment decreased and that for employment held around the low levels of the previous quarter (see Chart 28).

Finally, analysts' expectations as to the earnings growth of listed non-financial corporations recovered in Q2. Thus in that period the expected growth of EBITDA for the next 12 months was relatively high at nearly 25%, compared with an average of 19% in 2004. The long-term annual rate of change of profit rose slightly to nearly 12%.



**FINANCIAL TRANSACTIONS OF THE NATION**  
Cumulative four-quarter data

TABLE 7

% GDP (a)						
	2001	2002	2003	2004		2005
				Q3	Q4	Q1
NET FINANCIAL TRANSACTIONS	-3.4	-2.5	-3.1	-3.6	-4.1	-4.9
FINANCIAL TRANSACTIONS (ASSETS)	11.0	13.0	12.9	11.5	12.3	13.5
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	-2.6	3.3	0.7	4.2	3.6	3.7
Securities other than shares	6.9	4.1	6.5	1.5	1.7	2.4
<i>Of which:</i>						
<i>Credit institutions</i>	1.9	0.5	3.5	0.7	1.0	0.6
<i>Institutional investors (b)</i>	5.2	3.1	3.1	0.4	0.0	1.3
<i>Shares and other equity</i>	4.4	5.0	4.7	4.3	5.7	5.8
<i>Of which:</i>						
<i>Non-financial corporations</i>	3.9	4.8	4.5	3.3	2.6	3.4
<i>Institutional investors (b)</i>	0.4	-0.1	1.1	1.2	1.0	1.0
Loans	2.3	0.6	0.9	1.4	1.4	1.6
FINANCIAL TRANSACTIONS (LIABILITIES)	14.4	15.5	16.0	15.1	16.4	18.4
Deposits	2.5	4.0	6.9	2.9	1.7	2.2
Securities other than shares	2.9	4.3	5.3	10.7	12.2	12.6
<i>Financial institutions</i>	1.4	3.1	6.4	8.6	9.6	11.3
<i>Rest of resident sectors</i>	1.5	1.2	-1.1	2.1	2.6	1.4
Shares and other equity	4.4	4.0	1.1	-0.3	1.9	2.1
<i>Of which:</i>						
<i>Non-financial corporations</i>	3.8	3.3	1.3	0.3	0.9	1.3
Loans	4.2	3.3	3.2	2.5	1.6	2.1
Other, net (c)	0.5	0.0	-0.5	-0.7	-0.9	-0.6

SOURCE: Banco de España.

a. CNE, base year 2000.

b. Insurance corporations and portfolio investment institutions.

c. Includes the asset-side caption reflecting insurance technical reserves.

#### 5.4 General government

In 2005 Q1 the balance of the general government sector's net financial transactions was positive, making for a slight improvement in the sector's financial saving in cumulative four-quarter terms, which stood at 0.1% of GDP compared with -0.3% in 2004 (see Chart 29).

In terms of instruments, there was a net redemption of bonds by general government between January and March, although in cumulative four-quarter terms the funds raised in this way were practically nil. The net issuance of short-term securities in the first quarter of the year was positive and, in cumulative twelve-month terms, the funds received were also very low. Interest payments as a proportion of GDP continued to decrease thanks to the decline in financing costs.

#### 5.5 The rest of the world

The debit balance of the nation's financial transactions again worsened in 2005 Q1, reaching 4.9% of GDP in cumulative four-quarter terms, up 0.8 pp of GDP on 2004 (see Table 5). Sectoral analysis shows that the greater financing needs arose from the increase in the debit balance of households and non-financial corporations, which was not offset by the recovery in general government saving.

Investment in external assets by resident sectors in Q1 amounted to 13.5% of GDP in cumulative twelve-month terms, up 1.2 pp on the 2004 figure (see Table 7). There were slight chang-

**NET FINANCIAL ASSETS VIS-À-VIS THE REST OF THE WORLD (a)**  
**(Q4 data)**

TABLE 8

% GDP (b)	2000	2001	2002	2003	2004	2005 (c)
National economy	-26.1	-27.1	-30.0	-36.0	-42.1	-43.0
Non-financial corporations and households and NPISHs	-9.6	-10.6	-11.2	-13.6	-12.4	-11.6
Non-financial corporations	-16.6	-17.7	-18.0	-21.1	-20.6	-19.8
Households and NPISHs	6.9	7.0	6.8	7.5	8.2	8.2
Financial institutions	7.3	7.4	5.6	-1.3	-6.6	-8.6
Credit institutions (d)	-11.9	-14.1	-14.3	-21.7	-22.9	-24.3
Institutional investors (e)	20.1	23.3	23.4	26.4	26.6	27.5
Other financial institutions	-0.9	-1.8	-3.4	-6.0	-10.4	-11.8
General government	-23.7	-23.9	-24.4	-21.1	-23.0	-22.8

SOURCE: Banco de España.

a. Calculated as the difference between the stocks of financial assets and liabilities vis-à-vis the rest of the world according to quarterly financial accounts data.

b. CNE, base year 2000.

c. Q1 data

d. Defined in accordance with the First Banking Directive.

e. Insurance corporations and portfolio investment institutions.

es in the instruments with respect to the trends in 2004. Thus the volume of investment in currency and foreign deposits held steady as a proportion of GDP, while the acquisition of securities other than shares increased as a result of purchases by institutional investors. Moreover, the acquisition of shares and other equity abroad continued to account for a high percentage of the flows (5.8% of GDP), against a backdrop in which, on provisional balance of payments information, both direct and portfolio investment increased in buoyancy.

Net capital inflows amounted to the equivalent of 18.4% of GDP in cumulative twelve-month terms, up 2 pp on the volume posted in 2004. As regards instruments, there were increases in most headings, although the main source of funds was again the issuance of securities other than shares by financial institutions, which is the main way by which external funds are raised to cover the financing needs of Spain's economy.

Finally, as a result of these developments in inflows and outflows and of the changes in asset prices and the exchange rate, there was a fresh increase in the debit position of the Spanish economy vis-à-vis the rest of the world, which in 2005 Q1 stood at 43% of GDP. Sectorally speaking, these changes resulted in a worsening of the debit position of financial institutions, which was not offset by the improvement in the position of corporations and general government.

29.7.2005.